

STATE OF CALIFORNIA

**BIENNIAL REPORT**

of the

**JOINT LEGISLATIVE AUDIT COMMITTEE**

1965-1966



William H. Merrifield, *Auditor General*  
Lindsay W. Miller, *Committee Consultant*

**MEMBERS OF THE COMMITTEE**

**ASSEMBLYMEN**

Willie L. Brown, Jr.  
Ray E. Johnson  
Vincent Thomas,  
*Chairman*

**SENATORS**

Richard J. Dolwig  
Luther E. Gibson  
Hugh P. Donnelly,  
*Vice Chairman*

During the calendar years 1965 and 1966, the following members of the State Legislature were appointed to the Joint Legislative Audit Committee:

ASSEMBLYMEN

NICHOLAS C. PETRIS  
(served until 4/27/65)  
LEO J. RYAN  
(served until 12/28/65)  
RAY E. JOHNSON  
(served from 4/27/65  
to present)  
WILLIE L. BROWN, JR.  
(served from 12/28/65  
to present)  
VINCENT THOMAS, *Chairman*  
(served entire period)

SENATORS

RICHARD J. DOLWIG  
(served entire period)  
LUTHER E. GIBSON  
(served entire period)  
HUGH P. DONNELLY, *Vice Chair-*  
*man*  
(served entire period)

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## LETTER OF TRANSMITTAL

JOINT LEGISLATIVE AUDIT COMMITTEE  
CALIFORNIA LEGISLATURE  
April 15, 1967

The Honorable President of the Senate  
The Honorable Speaker of the Assembly  
The Honorable Members of the Senate, and  
The Assembly of the Legislature of California

Sirs:

We transmit herewith our report covering the activities of your Joint Legislative Audit Committee, for the calendar years 1965 and 1966.

This report discusses the work of the committee and the Office of the Auditor General. In addition, it describes our program of independent postaudits of the executive branch of state government.

During the past two years discussed in this Biennial Report we have issued a total of 153 reports of all kinds, containing 358 recommendations for improvements in accounting and related procedures. Of these recommendations, a total of 90 percent have been accepted and implemented by the state agencies concerned.

Our state government is composed of almost 200 separate departments, agencies, and offices. Each of these has been audited on at least one occasion during the lifespan of this committee. The high degree of acceptance and implementation of our recommendations indicates the responsibility of your committee, and the outstanding performance standards and technical competence of the Auditor General and his staff.

The nature of our assignment makes it most difficult to estimate the total savings in man-hours, administrative delays, and actual cash expenditures our recommendations have achieved. However, we can confidently claim to have returned to the people of the state, many times over, the operating costs of your committee and the Office of the Auditor General.



In conclusion, your committee pledges itself to continue aiding the Legislature in its duty to oversee the operations of the executive branch, and to aid the executive branch in establishing sound fiscal and administrative policies.

Respectfully submitted,

WILLIE L. BROWN  
RAY E. JOHNSON  
VINCENT THOMAS,  
*Chairman*

RICHARD J. DOLWIG  
LUTHER E. GIBSON  
HUGH P. DONNELLY,  
*Vice Chairman*

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**SENATOR HUGH P. DONNELLY**

State Senator Hugh P. Donnelly, Vice Chairman of the Joint Legislative Audit Committee, retired from the Legislature at the end of December 1966 after 32 years of state service.

First elected to the State Assembly in 1934, Mr. Donnelly served as Speaker pro Tempore of the House in 1939 before successfully seeking election to the State Senate in 1942. Since that time he continuously represented the 22d Senate District (Stanislaus County), and at the time of his retirement was the Chairman of the Senate Committee on Education and Dean of the State Legislature.

In 1955, Senator Donnelly authored Senate Bill 1540, which created the Joint Legislative Audit Committee and the Office of the Auditor General. He served as vice chairman of the committee up to the time of his retirement.

Without Senator Donnelly's guidance and leadership, the joint committee and the Office of the Auditor General would not have become effective instruments for the legislative branch. More than any other man, he was responsible for originating and carrying through to completion the concept of a legislative post audit function in California. He will be sorely missed by his colleagues on the joint committee.

The members and staff of the joint committee and the Office of the Auditor General wish Senator Donnelly many happy years of retirement. We hope he will visit us as often as possible, and maintain close contact with our work. For our part, we shall continue striving to improve our standard of performance, as he will expect us to do.

### SENATOR LUTHER E. GIBSON

A second member of the Joint Legislative Audit Committee has also retired from the Legislature, and your committee would like to pay tribute to State Senator Luther E. Gibson.

In 1955, Senator Gibson coauthored Senate Bill 1540, establishing the Joint Legislative Audit Committee and the Office of the Auditor General, and he served as a member of the committee until his retirement at the end of December 1966.

From 1948 until his retirement, Senator Gibson represented Solano County in the Legislature. Along with his membership on the joint committee, he served as Chairman of the Senate Governmental Efficiency Committee. In addition, he held membership on the Senate Finance Committee; the Senate Revenue and Taxation Committee; the Senate Transportation Committee; and the Senate Business and Professions Committee.

Senator Gibson is the publisher of a number of important newspapers in northern California, and by virtue of his wide experience both in private and public life he was able to render invaluable service to the joint committee.

The members and staff of the Joint Legislative Audit Committee and the Office of the Auditor General wish Senator Gibson a long and happy period of retirement. We hope he will visit us often in Sacramento, and maintain close contact with our work.

The reappearance and an accompaniment, has brought the legislature a large presence in state of the State public office of newly elected previous legis

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INTRODUCTION

The reapportionment of the California State Senate, and an accompanying wave of resignations and retirements, has brought into office in both Houses of the Legislature a large number of members without prior experience in state government. The 34 newly elected members of the State Assembly in almost all cases are holding public office for the first time, and a number of the 22 newly elected members of the State Senate do not have previous legislative service.

To aid the new members in understanding the operations and programs of the Joint Legislative Audit Committee and the Office of the Auditor General we have completely revised our required *Biennial Report* to the State Legislature. It is our hope the report will describe our work of the past two years and our plans for the future in concise terms, and that separation of subject matter into chapter form will facilitate ready access for reference purposes.

In our last *Biennial Report*, for the period 1963-1964, we reported to the State Legislature that the Joint Legislative Audit Committee had issued a total of 131 reports of all kinds containing 400 recommendations for improvements in accounting by agencies and funds of the state.

We also reported, that a total of 72 percent of these recommendations were accepted and implemented by the state agencies concerned.

We now inform the Legislature that for the immediate past two years discussed in this *Biennial Report* a total of 153 reports of all kinds were issued, containing 558 recommendations for improvements in accounting and related procedures.

Of these current recommendations, the Joint Legislative Audit Committee notes with satisfaction that a total of 90 percent have been accepted and implemented by the state agencies concerned.

This significant increase in the number of our recommendations accepted points up the desire at almost all echelons of state government to improve financial and

working procedures. In addition, we believe the Legislature can take pride at this indication of the operational effectiveness of the Office of the Auditor General.

We would like to take this opportunity of thanking the personnel at all levels in state government who have cooperated with your committee and have helped to make this record of accomplishment possible. We also commend the Auditor General and his dedicated staff for their valuable service over the past two years.

During the past 10-year period, the Office of the Auditor General has established a reputation across the nation which brings considerable credit to the California State Legislature. In recognition of this fact, Members of the Legislature may be interested to know that former members of the Auditor General's staff are now serving as Chief Fiscal Officer of the California State Assembly; Chief Deputy Controller of the City of Los Angeles; Chief Accountant of the City of Long Beach; and a number hold major positions with nationally ranked private firms.

In addition, the State of Alaska called upon the Auditor General for advice and assistance in 1964 while that state was preparing to establish an internal auditing system, and currently a member of the Auditor General's staff on leave of absence is assisting the Kingdom of Thailand in the development of governmental auditing procedures.

The Auditor General also receives many invitations to address professional gatherings, both in California and in other parts of the country. In recent months, at no expense to the state, he has spoken before the California Assessors Convention; a seminar sponsored by the Hawaii Society of Certified Public Accountants; and in November 1966 at the invitation of the Legislative Audit Commission of New Mexico he traveled to Santa Fe to discuss the organization of an Auditor General's office in that state.

It is clear that California is one of the leaders in the field of legislative postauditing, and increasingly we are becoming the model for others to follow.

The joint committee has been pleased by the increase in the number of requests for information received from members and committees of the State Legislature. A total

of 26 such requests were received during the year period.

These include the Senate Transportation Committee; the State Bar of California; the State Education Organization; the State Assembly Education Committee; and the State Bar of California.

In conjunction with the services of the Members and the staff, that we can conduct research and analysis.

Your joint audits for the past year, which represent approximately 25 percent of the agencies of the State, are the reports issued in Appendix A.

As we have seen, at all echelons of state government, over the years, but we are on the part of the personnel to implement addition, in a long standing tradition, follow we discuss which fall into the category of should be of interest.

We would like to see the reports in final form. The reports are distributed to the personnel of the Legislature.

Wherever possible, the reports are directed and produced with publicity. As we see, the executive branch is paying public attention to the dramatize the purpose or means.

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of 26 such requests were received during the past two-year period.

These include requests from the Speaker's office; the Senate Transportation Committee; the Senate Finance Committee; the Assembly Committee on Government Organization; the Assembly Rules Committee; the Assembly Education Committee; the Joint Budget Committee; and the Joint Retirement Committee.

In conjunction with our regular audit program the services of this committee are always at the disposal of Members and committees of the Legislature, and we trust that we can continue to provide a valuable information and research source for our fellow legislators.

Your joint committee approves the annual schedule of audits for the Office of the Auditor General, and we inspect approximately one-third of the departments and agencies of the state each year. A complete summary of the reports issued during the past four years is contained in Appendix A of this *Biennial Report*.

As we have stated, the cooperation received from most echelons of state government has been excellent in recent years, but we have found, in some instances, a reluctance on the part of departmental or agency supervisory personnel to implement necessary changes in procedure. In addition, in a few cases we have found that problems of long standing are still not resolved. In the chapters that follow we discuss as briefly as possible a number of cases which fall into one or both of the above categories, and should be of interest to every Member of the Legislature.

We would like to emphasize that, before being prepared in final form and released for distribution, all our audit reports are discussed with appropriate management level personnel of the agencies concerned.

Wherever possible, we try to have deficiencies corrected and procedures improved without unnecessary publicity. As we see it, our role is to aid the Legislature and the executive branch in their responsibilities to the tax-paying public, and your committee does not seek to dramatize the problems of government for any partisan purpose or motive of self-interest.

The joint committee also is deeply indebted to Dr. Dennis M. Knighton, assistant professor of accounting, University of Texas, for much of the information con-

tained in the chapters on "The Performance Postaudit," and "Program Budgeting and Program Accounting."

Dr. Knighton devoted considerable research and scholarship to his 1966 Ph.D. thesis on these subjects at Michigan State University, and he personally visited a number of important states to inspect the offices of the Auditors General at firsthand. As a result, we have probably the most complete examination and appraisal of the legislative postaudit function available anywhere today, and the insight Dr. Knighton has been able to give us on progress made in other states has been most useful to our work.

The concepts of performance postauditing and program budgeting represent a major step forward in the administration and operation of state government. This is true for states all across the nation, and particularly true for California due to the complexity and scope of our problems. Your committee is hopeful that the chapters on these subjects will be read carefully by all members of the legislative branch; the executive branch; and serious students of government throughout the state.

We believe that as our annual state budget surpasses \$5 billion we must find new legislative and administrative controls if we are to prevent the complexity of the budgetary process from overwhelming both elected and appointed officials.

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## CHAPTER ONE

### THE PERFORMANCE POSTAUDIT--BOLD NEW CONCEPT FOR THE FUTURE

In the past, state postaudits generally have been limited to examinations of financial transactions and internal controls in an attempt to establish that funds have been legally and honestly spent. Such an audit is important, but we believe it is inadequate for the needs and purposes of the modern Legislature.

The legislative branch has the responsibility not only to pass laws, approve programs, and authorize expenditure of funds. It must also review administrative performance, and determine that laws and programs are operating in the public interest. In addition, without an independent review and appraisal of agency activities even executive branch officials cannot know whether decisions are being fully implemented, and whether programs are achieving desired results.

Following creation of the joint committee and the Office of the Auditor General 10 years ago, audit staff members conducting reviews and inspections of executive branch agencies saw the need to review management as well as strictly financial procedures. In fact, many difficult accounting problems could not be resolved without accompanying changes in management procedures.

Traditional limits on work conducted by the Office of the Auditor General are not realistic, and the joint committee found it was not utilizing the full potential of the staff by insisting upon them. **Accounting is the language of business**, and modern-day large corporations appreciate that qualified, highly trained auditors are in a better position than most administrative personnel to understand complex procedures and to make recommendations for improvements and change.

Over the past several years almost every state in the nation has undertaken a study of the adequacy of its postaudit program. Many states have followed the example of California and have created an Office of the Auditor General under the authority and control of the legislative branch. In fact, in this field California has set many of the standards for others to follow.



One state, however, has gone further than California in this regard. In 1963 the citizens of the State of Michigan approved a new State Constitution which became effective the following year. Article IV, Section 53 of the new Constitution states in part:

"The legislature . . . shall appoint an auditor general, who . . . shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and **performance post audits** thereof." (Emphasis added.)

This action by the State of Michigan is significant because not only has the role and function of the Auditor General been written into the State Constitution, but the modern concept of a performance postaudit has been given Constitutional recognition and sanction.

If fully implemented in California, we believe the concept of performance postauditing would give the State Legislature access to information vitally necessary to the accomplishment of the legislative role in government. Definition follows:

**A "performance post audit" is an independent examination, conducted by the Auditor General, for the purpose of providing the Legislature with an evaluation and report of the manner in which administrators of agencies and departments of the state have discharged their responsibilities to faithfully, efficiently, and effectively administer programs of the state.**

**Faithfulness** refers to whether or not programs have been administered in accordance with promises made to the Legislature and the expression of legislative will. **Effectiveness** refers to whether or not planned program objectives have been achieved. **Efficiency** refers to whether or not program accomplishment has been achieved by using the least cost combination of resources with a minimum of waste.

Staff auditors of the Office of the Auditor General have been increasingly conducting a form of performance post auditing in their reviews and inspections of state agencies, and this is most clearly illustrated by the chapter on the Division of Highways contained in this *Biennial*

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*Report.* However, so far the concept has not been fully discussed with all members of the State Legislature.

For purposes of this discussion we are most fortunate in having available to us a recent study and analysis of legislative postauditing across the nation. The study was prepared by Dr. Lemmis M. Knighton, assistant professor of accounting, University of Texas, as part of the requirement for his doctoral degree at Michigan State University. Much of the information contained in this chapter and the one that follows is drawn from Dr. Knighton's thesis, and we are deeply grateful for the help he has afforded us in our work.

As Dr. Knighton points out, the concept of the performance postaudit has not suddenly appeared on the governmental scene, nor is it something that just caught the fancy of delegates to the Michigan constitutional convention. Instead, seen in its proper context, the performance postaudit is a natural consequence of recent major developments and trends in state government, and potentially can be an important tool for preserving the democratic state system.

When state programs were few and reasonably simple, it was not difficult for legislators to monitor the operations and activities of departments and agencies. But when programs number in the hundreds and state budgets run into billions of dollars the possibility of any close legislative control is lost. As a result, much budget authorization becomes an analysis of changes or additions to existing programs, and seldom are major programs called into serious question. To an unfortunate extent, many state legislatures across the country have come to be nothing more than rubber stamps for executive requests.

As the Citizens Research Council of Michigan said in February 1962:

"There has been little . . . emphasis on the creation or improvement of legislative tools to enable the legislature to keep abreast of developments in the executive branch, in order to make prudent legislative policy with respect to it. While it is not intended here to suggest that the legislative branch should keep pace with the executive branch in growth of personnel and expenditures, it is clear that the expansion and increasing complexity of the

executive branch challenges the legislature's ability to maintain its role as a separate and equal branch of government exercising effective checks on the executive branch."

The California State Legislature has been more successful than most in keeping pace with the expansion of the executive branch, but authorities generally recognize the postaudit function as the one tool still available to insure executive compliance with legislative policies and to hold administrative officials accountable for their actions.

However, Dr. Knighton emphasizes this important point:

"The problem is not so much how legislative control can be increased, but rather how the legislature may exercise appropriate kinds of control without impeding administration or weakening executive authority. In a system of balance of powers, an imbalance in favor of the legislative branch can be just as serious a problem and perhaps more serious than an imbalance in favor of the executive branch. The objective sought by improving legislative control is to improve the quality and efficiency of public programs, not to hold down executive officials. And control methods which are appropriate in this sense are those which facilitate administration while keeping the legislature fully informed on what is transpiring."

It is clear that to fully accomplish the aims of the performance postaudit it will be necessary to have an expression of legislative intent in every statute affecting the conduct, organization, or programs of any state agency. In addition, it is important that the Legislature receive from the Governor, or other executive officials, a statement of intent for every program proposed or budget requested.

This suggestion is not designed just to simplify the work of the staff auditor. Such a requirement would prove invaluable to agency administrators, other executive branch officials, judges and juries, and everyone charged with responsibility to interpret legislative will and to judge performance against it.

The formulation of clear expressions of intent for all major programs requested or adopted obviously presents difficulties, but a number of states are attempting to move

in this direction. Knighton says:

"In review it is imperative that objectives so clearly defined, objectives of service, or the specific performance program accomplishments necessary for the responsibility properly fulfilled, provide adequate each program standards and objectives."

"All of this, of course, be without in administrators, burdens, usurping the their administrative hired to bring."

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As Dr. Knighton says:

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in this direction. Touching upon this problem, Dr. Knighton says:

"In reviewing any such statement of policy or intent, it is imperative that the legislature first agree upon the objectives sought by the program being acted upon. Such objectives may be given in terms of productivity, level of service, or state of condition. It is also important that the specific standards of achievement or standards of performance to be used in appraising the results of program accomplishment be identified. It is further necessary for the legislature to require a clear assignment of responsibility, for programs to be clearly defined and properly funded, and for a system to be established to provide adequate reporting and secure accountability for each program and appropriation in terms of the standards and objectives specified.

"All of these standards and specifications must, of course, be useful in giving direction to administration without in any way stifling initiative on the part of administrators, interfering with proper management functions, burdening officials with unnecessary paper work, or usurping the right of management to bring to bear on their administrative problems the expertise they were hired to bring to their jobs."

We believe the Auditor General is the Legislature's arm for on-the-spot reviews of administrative performance. In fact, the staff auditors of the Auditor General are the only employees of the State Legislature who on a daily, weekly, and monthly basis travel throughout the state inspecting at firsthand the operations of the many agencies and departments of state government.

The staff auditor's role is that of reviewing administrative activity, and reporting his findings to the Legislature. Areas of state activity subject to this review properly include all areas upon which the Legislature needs information, and which fall within the competence of the auditor.

As Dr. Knighton states in his thesis:

"Admittedly this role is much broader than the traditional financial audit, but it cannot logically be viewed any other way. To argue that the audit should be confined to financial transactions is to deny that the legislature is in need of information other than that of a

financial nature or to assert that the auditor is incompetent to perform an examination and render an opinion on performance in non-financial areas. Neither of these positions can logically be supported. The function of the legislature includes a review of all administrative activity. The role of the auditor is to help the legislature perform such a review, and this he cannot do without extending his review beyond the financial area . . .

"As stated by the Auditor General of Illinois, 'The audit of a State agency has multiple objectives, only one of which is the opinion on the financial statements.' By calling attention to strengths and weaknesses, and by identifying problem areas, even though he may not always be able to competently recommend solutions, the auditor performs an invaluable service to the Legislature whom he is constitutionally required to serve."

Basically, the functions of the staff auditor are to examine and evaluate records and controls of an organization for the purpose of issuing a report on the organization's condition and performance, and additionally to make recommendations for improvements where needed.

It is not the function of the auditor to impose his will on the organization, or to try to enforce any rule or policy. It is also not the function of the auditor to establish and maintain systems of accounting or controls, and he must not interfere in any way with decisions and prerogatives of management.

The staff auditor's recommendations may take various forms, but they should not go outside his area of competence. Where the auditor feels special studies are needed he should recommend that other experts more qualified in the particular subject area be employed.

For example, the staff auditor is not a highway engineer and an investigation to determine how long it might take to build a highway of a certain size and quality is beyond his area of competence. However, an inquiry into why it took two years instead of a scheduled one year to build a highway does fall within his area of operations.

It is not beyond the auditor's competence to determine the cost of operation for a department at the state university. However, he would more appropriately draw a

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comparison between the costs of one such department and another of similar size and scope.

In the treatment of mental patients or the rehabilitation of prisoners at a state correctional facility, it is beyond the auditor's area of competency to determine what such services "should" cost. However, once again, he can make comparisons between similar mental hospitals or correctional facilities and base his recommendations accordingly.

The staff auditor cannot judge how much it should cost to build a state office building of a certain size and capacity, but he can certainly conduct an examination to determine why such a building costs more than it was originally intended to do.

In addition, government output primarily takes the form of services to the public. It is difficult to place any meaningful financial value on many of these services. As a result, efficiency in government does not lend itself to measurement as readily as it would in an industrial plant.

On this point, Dr. Knighton says:

"First, unlike a commercial enterprise which measures efficiency in terms of profit or contribution to profit, a government agency such as the conservation department must relate cost inputs to trees planted, to wildlife preserved, or to parks maintained. Thus efficiency cannot be measured in financial terms. As one writer points out, however, 'This does not mean necessarily that figures cannot be developed which will indicate a measure of efficiency. It means only that figures developed according to the conventional pattern are simply not valid for this purpose.' Some writers have suggested that unit costs be developed, such as cost per patient day, cost per credit hour, cost per full-time equivalent student, or cost per mile of highway services. Obviously these measures have serious deficiencies too, but they do represent what seems to be the most promising approach yet suggested for developing standards of judging efficiency in government. Much progress has been made in some areas, such as hospitals, but more needs to be done before such unit measurements will be fully effective. And even if such unit costs are developed on a wide basis, the auditor will still need to be extremely careful in applying them to a given agency or institution since there exists a wide

variety both in size and type of activity among agencies of different states and locations."

The function of management can be broken down into three basic component parts of planning, executing, and reviewing. It is clear that if the staff auditor is to review administrative performance he cannot confine his inspection to the execution phase alone, although this will constitute a major part of his work. He must also inspect both the planning process and the review process. In addition, the auditor must examine not only what has happened but what was expected to happen, and he must question the adequacy of the plan as well as the propriety of the execution.

This does not mean that the auditor should attempt to second-guess management either in terms of the objectives sought, or the programs developed. However, he must ask the following questions:

Is the control system adequate to insure that stated objectives will be met?

Are stipulated standards both relevant and useful?

Are the programs internally consistent?

Is responsibility and authority clearly defined?

Have alternatives been fully explored?

Do old programs continue to serve their intended purpose?

Are budgeting and accounting systems consistent with the patterns of responsibility and the programs developed?

As the staff auditor's role in government increases it is understandable that management level officials become apprehensive about the scope of a comprehensive post-audit program. On this point, the Auditor General of Illinois has this to say:

"... Each individual auditor ... has an obligation to conduct himself ... in such a manner that he promotes the over-all constructive objectives of the post-audit program. The surest way ... to hurt the program is to give agency personnel the impression that the auditor is part of a 'Gestapo' or spy organization or that he will try to pillory them for every small error in judgment or departure from the statutes and regulations. While the audit reports must include disclosure of any

instances of failures, inefficiencies, or waste in carrying out that agency's mission, in most cases the deficiencies are corrected through improved procedures on the part of the agency. The purpose behind the suggestions should not be to make anyone feel so bad that they are blinded by commendation.

In regard to the committee can or cannot comment and we will be the Office of the Auditor General.

In conclusion, the audit does not take any action for the purpose of bringing out the results of a program in the future.

The chapter of the Legislative Auditor's report to make the recommendations by a committee.

If the legislative control element support of the members of the committee is a view to increase interest in the audit, it may hold for the future has been v

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instances of wasteful procedures, improvident expenditures, ineffectual controls, and unbusinesslike methods in carrying out programs, each auditor should not forget that agency personnel are the individuals that will in most cases have to take the necessary action to correct deficiencies and . . . to place recommendations for improved procedures into effect. An antagonistic attitude on the part of agency personnel, even with an honest purpose behind such antagonism, may negate the best of suggestions. If it can at all be avoided, agency personnel should not be put into a defensive position where they may feel so compelled to justify past actions that they are blinded to the positive aspects of an auditor's recommendations."

In regard to the above advice, the Joint Audit Committee can only say that it is in complete and total agreement and we know our views are shared by the staff of the Office of the Auditor General.

In conclusion, this discussion of the performance post-audit does not attempt to outline a complete program of action for the legislative branch, and it does not attempt to bring out in depth all the problems and aspects of such a program in operation.

The chapter is intended solely to familiarize Members of the Legislature with the concept in a broad sense, and to make them aware of a general movement in this direction by a number of other states.

If the legislative postaudit is to become an effective control element in state government, it must have the full support of the legislature it is designed to serve. The members of your committee hope this chapter will provoke interest and general discussion of the subject with a view to increasing awareness of the benefits the concept may hold for our California state government. The chapter has been written with this thought in mind.



## CHAPTER TWO

### PROGRAM BUDGETING AND PROGRAM ACCOUNTING

During the 1965 session, the Governor submitted a report entitled "Sample Program Budgets" to Members of the State Legislature. This report contained examples of program budgets for a number of state agencies, and while the samples given fell short of reaching the goals desired they did represent an attempt to break ground with a new concept of governmental budgeting.

The concepts of program budgeting and program accounting are so closely related to the performance post-audit discussed in the last chapter, and they have so much relevance to the work of the Office of the Auditor General that we would like to devote this chapter to the subject. Once again, we are indebted to Dr. Lennis M. Knighton for much of the information available to us on the topic area.

Of all subjects relating to the fiscal affairs of state government, none has been more debated and discussed across the country in recent years than the concept of program budgeting. Dr. Knighton believes the term is familiar to virtually every governmental employee in the United States, but he doubts that more than a few of them understand its full meaning and significance.

It is clear that the term *program budgeting* means different things to different people, or as one writer explains:

"To a student of politics and of legislative bodies, it means perhaps a reduction of appropriation items, a rationalization of the appropriation structure in terms of programs, a presentation and review of budget requests in such a manner as to emphasize issues and to make possible more effective choices. To a top administrator, it means these things and also greater flexibility and discretion in his operations, plus better control and accountability with regard to subordinates. Down the line of an agency, it may mean a single source of funds, an enlargement of authority, flexibility, and responsibility in the use of the funds, and a mechanism for relating program planning with financial planning. To the accountant, it means accrual accounting, cost accounting, segregation of capital

from operating accounts, working capital funds, and many other techniques."

In recent years thousands of pages of print have been devoted to discussions of various budget concepts. These include program budgeting, performance budgeting, cost-based budgeting, line-item budgeting, and many others. Lengthy debates on the relative merits and weaknesses of each of these systems have taken place, but it is generally agreed by experts all across the country that the traditional line-item budget used in state government is no longer sufficient or informative enough for the modern-day needs of the legislative branch.

State budgeting cannot be accomplished without serious consideration of program implications and objectives, and for purposes of this discussion the term *program budgeting* will be used to define the process of allocating state revenues on the basis of programs and expected program achievements. In fact, a program budget is the expression of program plans in terms of dollars and cents.

In his dissertation, Dr. Knighton stresses the following:

"In spite of the theoretical arguments favoring a program budget, no state in the United States has yet developed such a budget. Several states have made some progress in this direction . . . but none have yet succeeded. Most state budgets are still prepared on the basis of objects of expenditure. Consequently, budget authorizations detail the funds to be spent for tires or uniforms or light bulbs, and the financial reports give detailed descriptions of where the money went. Such a system, as [Jesse] Burkhead explains, 'shows **what** government purchases but not **why**': accordingly, it does not show the nature of governmental programs, or accomplishments under those programs.' As a result, agency administrators are held accountable for the supplies they buy and the people they hire but not for the achievement of program objectives.

"Charged only with spending the funds allotted for acquiring supplies and personnel, administrators have little incentive to economize on the use of funds. Funds found to be in excess of current needs are often spent for additional supplies or other items such as sidewalks and landscaping. The measure of successful administration is frequently based on how much can be spent rather

than on how major attempts to determine funds normal mental changes tiny. In brief: resources is budget."

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than on how much can be achieved. Furthermore, few major attempts are made to review continuing programs to determine whether they continue to need the sum of funds normally allotted. Only new programs and incremental changes in old programs are given careful scrutiny. In brief, efficient and effective use of the state's resources is not fostered by a line-item appropriation budget."

Program budgeting, however, does provide the incentives discussed above. Under program budgeting administrators are granted specific funds to achieve specific goals, and budgetary control comes from determining whether funds granted have been used efficiently and effectively in achieving program objectives. Therefore, management is motivated to improve operating procedures, to economize in purchase of supplies and in hiring of personnel, and to combine all resources available for the successful completion of program goals.

Another advantage of program budgeting is that it provides a control over the kind of things government does. One writer on the subject notes:

"Line-item budgeting without other planning or program stipulations can also favor extensive administration leeway. Diminution of one program may free manpower and supplies for another. When this goes unstated and unaccompanied by budgetary reductions, the . . . officer working within administrative rules and a statutory framework that he well understands may undertake major new programs, or even traditional ones that have been most scrupulously vetoed previously."

As has been said, no state at present has a true program budget fully implemented and operating. However, several states have made progress in this direction although a vast amount of work still has to be done.

In his thesis, Dr. Knighton relates that his preliminary research seemed to indicate a number of states and cities had made substantial progress in developing program or performance budgets. However, as he checked out each of these claims he found that actual progress in most cases was significantly less than the claims would indicate.

For example, several articles in professional journals indicated that the State of Maryland had brought about substantial revision of the budget process, and had fully

developed a program or performance budget. The new budget was reported to offer considerable improvements not only for managerial decisions and control, but for legislative review as well. One writer stated that, "among the states, Maryland is a pioneer in program budgeting . . . The Maryland system is significant because of its comprehensiveness." The same writer claimed that other states were also utilizing the concept, among them Illinois and Michigan.

Dr. Knighton points out that these statements were made in 1957, but not until 1966 did Michigan present its first sample of program budgeting. The State of Illinois denies having used a program budget so far, and an examination of the 1966 Maryland budget reveals no program breakdown, no identification of program objectives, no program justification in terms of services rendered or products produced, and no evidence that these items have been clarified and developed. What Dr. Knighton did find was a budget prepared in terms of broad functional activities, which though probably an improvement over line-item expenditures can hardly be classified as a program budget.

Additionally, a budget officer in New York indicated in 1960 that his state had conducted a major study to program all state activities and was ready to enter into a program budgeting system. However, a visit by Dr. Knighton to New York in 1966 failed to establish any broad development of the type and scale claimed. What Dr. Knighton did find was that considerable effort had been made to program the activities and budget of one department—the Department of Taxation and Finance—and work is underway on other departments of state government.

Based upon experience gained with programming the above-named department, the State of New York prepared and issued an instruction booklet on planning-programming budgeting which outlines the basic policy and approach to be used by other state departments. Additionally, the accounting systems in the State Department of Education and the state university are being converted to a program basis. Clearly, the State of New York is moving into a leadership position in the field of program

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As required all agencies and reorganized into therefore, has the reorganization selected for initiated prepared and a program basis. Knighton indicated identifying major considerable work objectives are

Seemingly, the budgeting has taken the Department of Defense used, probably involved, but it does could provide bodies.

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budgeting, but as state officials quickly admit—they are just getting off the launching pad.

As required by the new Michigan State Constitution, all agencies and departments of that state were recently reorganized into 19 major departments. Budget emphasis, therefore, has been placed on problems associated with the reorganization. However, two state departments were selected for initial programming and their budgets were prepared and submitted to the Legislature in 1966 on a program basis. An analysis of these budgets by Dr. Knighton indicates that substantial progress was made in identifying major activities and functional areas, but considerable work still has to be done before the full objectives are met.

Seemingly, the most notable progress in program budgeting has taken place at the federal level in the Department of Defense. Little has been written about the system used, probably because of the classified information involved, but it does appear as though details of this system could provide substantial help to other governmental bodies.

President Johnson issued a memorandum on August 25, 1965, to the heads of all federal agencies, which stated in part:

"At the Cabinet meeting today, I announced that we would begin to introduce a new planning-programming-budgeting system in the Government. This will be a large and important job. I want all of you to devote personal attention to it . . . You should begin at once to develop plans for the creation of your program planning staffs. I want you to get the best people possible for these staffs both from within your organizations and from outside of Government."

The Rand Corporation had been working on a comprehensive study of program budgeting for some time, and following the President's indication of interest the corporation made a report of its study available to departments and agencies of the federal government. Dr. Knighton believes this report constitutes the most advanced and penetrating study yet made on the subject, but even here the problems identified are more numerous than the solutions offered. In fact, the point is made repeatedly in the study that its purpose is to provoke further discussion and

for efficient performance is a fundamental principle. If individuals are to perform efficiently, they must know what is expected of them, and they must be accountable for their performance by management. This is the essence of the principle."

One writer cause people entered. That is something has for success. Yet the mess in government indication of the

Two methods suggested by experiment. The first is the second on the

There are good reasons why these trees are identifiable as being planted, processed, galled, and constructed, and numerous other problems, however, problems that are not planted on hills, built within the desert, across desert walls, or enough, other factors.

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“ . . . performance standards can be defined as a statement of the conditions that will exist when a job is well done. At the program level, the ‘job’ is achieving the objective. Thus program standards are statements of conditions that will exist when the objective is achieved. And for every activity or job assignment within the composition of the program, equally appropriate standards are applicable. Fixing responsibility for each individual

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for efficient performance according to established plans is a fundamental concept of management control. If such individuals are to be held accountable for performance, they must know precisely for what and to whom they are accountable. And their performance must be reviewed by management and evaluated in terms of the standards set. This is the essence of effective and efficient performance."

One writer contends it is difficult to define success because people are more failure oriented than success oriented. That is to say, it is much easier to determine when something has failed or gone wrong, than the extent of its success. Yet the standards needed to measure effectiveness in government are precisely those that can give an indication of the degree of success.

Two methods of selecting performance standards are suggested by experts in the field as appropriate for government. The first is based on end products produced, and the second on the activity or work performed.

There are government programs where end products are identifiable and measurable. For example, tax returns processed; gallons of water provided; and number of trees planted. Others could include miles of highway constructed, and number of students graduated. In each case, however, problems of homogeneity arise. Were the trees planted on hills or level ground? Were the highways built within the city limits, in mountain canyons, or across desert wasteland? A single statistic is not always enough, other factors must also be considered.

Another weakness in output statistics is the inability in most cases to include quality estimates that can be evaluated. The quality of education cannot be measured by the number of graduates, and the same is true of the quality of medical treatment, public safety, or criminal rehabilitation. However, it must be recognized that someone can make a quality judgment if the right combination of statistics are available.

A performance standard based upon the activity or work performed is theoretically inferior to the end-product method. Nevertheless, this is the system likely to be used in most state agencies for the simple reason that meaningful output statistics are not available.

Under this system, education would be evaluated in terms of equivalent full-time students taught; number of credit hours taught; or number of classes held. The relevant standards are based on what is done, and not on what is accomplished. The difference is significant. As one writer explains:

"Measuring accomplishment and measuring work performed are not the same thing. Work performed is the process or the activity; accomplishment is the end product. . . ."

#### **Program Accounting**

Without program accounting the concept of program budgeting can never be fully implemented. In fact, the success of a program budget depends on the sufficiency, accuracy, and relevancy of a supporting system of program accounting and reporting.

Most accounting in government is done in terms of funds spent and funds received. Funds spent, however, cannot be a measure of performance. The goal is performance, not expenditure. Therefore, to account for the means and to ignore the goal is incomplete and meaningless accounting.

The key to program accounting and performance statistics lies in development of the useful performance standards discussed previously. If standards are measurable, objective, and significant, performance measurement becomes possible. To the extent that performance measurement is possible, records can be kept to report performance on both a program and a responsibility basis.

The type of accounting system needed is one which serves several purposes. It will not only measure program accomplishment and match such accomplishment with program cost, but also record and report costs and achievements based upon areas of responsibility. It differs from traditional governmental accounting in that it records and reports on cost effectiveness, whereas traditional accounting uses only revenues and expenditures. Program accounting in government is closer to cost accounting in private industry. A major difference being that in government productive units are frequently not available, and therefore output or accomplishment cannot be measured in the same way.

An excellent managerial accounting system in the State of New York was established by the Legislative Budget and Finance Committee. A representative of the Public Accounting Committee, and a representative of the Finance Committee, with the two a

It was recognized that improvements could be made in budgeting. On that any system would be well for the purpose of reporting. Further, it emphasized the importance of reporting for the determination of the needs of individuals.

The committee recommended that the State Department of Education, in carrying out this study, should guide the development of the system. Two special emphasis on achievement.

In conclusion, ". . . the system is a major criterion as it has been accounting and the emphasis is placed on the achievement rather than on the acquisition. In the long run, the system is by program for objects of importance.' It takes years to resolve considerable results. The goal is to be a fully revised



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An excellent example of the shift in emphasis to a managerial accounting system is the work currently underway in the State of New York. In 1960, the Governor of the state established a Joint Statewide Accounting Improvement Committee. The committee consisted of a Deputy State Comptroller, and a Deputy State Budget Director. A representative of the New York Society of Certified Public Accountants was designated as adviser to the committee, and a group of departmental officials with experience in financial affairs was established to work closely with the two appointed committee members.

It was recognized by the committee that accounting improvements could not be divorced from improvements in budgeting. One of the first established requirements was that any system developed would have to serve equally well for the purposes of budgeting, accounting, and reporting. Furthermore, the program of the committee emphasized the integration of budgeting, accounting, and reporting for state government as a whole with recognition of the need for flexibility to meet the varying requirements of individual departments.

The committee began its work with a pilot study in the State Department of Taxation and Finance, and following this study formulated several basic principles to guide the development of a new or revised accounting system. Two significant features of the system were its emphasis on responsibility accounting, and program achievement.

In conclusion, we again quote Dr. Knighton:

"... the system adopted by New York meets every major criterion . . . for a state accounting system, so far as it has been developed. It is based upon responsibility accounting and reporting concepts, and the major emphasis is placed on the purpose or objective to be accomplished rather than on the nature of the goods or services acquired. In the words of the Joint Committee, 'accounting by programs has been emphasized, while accounting for objects of expense has been given considerably less importance.' The remaining problems may take several years to resolve, and the system undoubtedly will yet need considerable refinement. This is expected, and it should be. The goal is not to have half a loaf today or tomorrow, but a fully revised and effective system developed as soon

as possible. Certainly the state is to be commended for its progress to date."

In our opinion, every effort should be made to implement program budgeting and program accounting in the state government of California. Qualified personnel are available within the executive branch, and we strongly recommend that the necessary studies and surveys be undertaken at an early date. Under professional direction, California has sufficient potential to become the national leader in this field, and by so doing can perform a real service for the people of our state and state governments across the land.

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### CHAPTER THREE

#### TRANSPORTATION AGENCY—DIVISION OF HIGHWAYS

During the past year a total of five major reports, and a number of later supplementary letter reports, have been issued as a result of the Auditor General's examinations of the State Highway Fund and the accounting procedures of the State Division of Highways. The first three major reports resulted in hearings before a joint meeting of the State Senate and Assembly Transportation Committees in Sacramento on August 11, 1966, and a later hearing before the Assembly Transportation and Commerce Committee in Los Angeles on September 14, 1966.

We believe that the California State Division of Highways ranks second to none in the nation for technical competence. However, the emphasis on engineering and related performance has not been carried over into the field of accounting and financial procedures, and it is with these procedures that this chapter concerns itself.

#### REPORT NO. 1 — REVIEW OF ACCOUNTS RECEIVABLE AND RELATED ACCOUNTING ACTIVITIES

##### (a) *Accounting for work done for others:*

Almost one-half of the amounts expended by the Division of Highways are provided by others for the accomplishment of specific work. Work performed for the federal government under various road programs averages nearly \$300 million annually, while work performed for other political subdivisions averages \$20 million annually. For the most part, payment is received after completion of the work. However, in some cases deposits are made before the work is undertaken.

As federal road programs grew in size, and with the addition of the interstate system, an increasing amount of state funds was used to advance the federal share of costs. At the end of June 1966, over \$100 million was receivable from the federal government. The lapse of time before recovery of these expenditures can vary from a few days, to months, and in some cases, even years.<sup>1</sup>

In an effort to speed repayment of funds to the states, the Federal Bureau of Public Roads developed the **current**

<sup>1</sup> By February 28, 1967 the amount due from the federal government exceeded \$140 million.

**billing-concurrent audit** method of accounting. Under this method, states recover each month most of the federal share of the previous month's cost.

In order to qualify for this method of repayment various control procedures must be incorporated into the accounting system of the state highway department to afford assurance that costs are accurately accumulated and reported. At present, **42 states** are being repaid under this system.

For many costs, the current billing-concurrent audit program substantially reduces the time the state must wait for repayment. Furthermore, it appears that states operating under this system recover costs which California does not.

The Joint Audit Committee recommended in 1962 that the Division of Highways take such action as may be necessary to adopt the concurrent audit procedure.

In answer to this recommendation, the State Highway Engineer replied on August 27, 1962, that the division recognized the benefits from the procedure, would assign a high priority to it, and estimated that from **18 to 24 months** would be required to accomplish the objective.

More recently, we were informed that the tentative date for adoption of the system would be July 1, 1966—a total of four years since the original recommendation. However, the concurrent audit method has still not been adopted by the Division of Highways as of the close of the year 1966.

The principal problem preventing adoption of current billing-concurrent audit in 1962, and continuing to the present, is the failure of the division to provide a cost accounting system which segregates recoverable costs from other costs.

As of June 30, 1966, our figures show that approximately \$100 million was outstanding in claims against the federal government. We believe that if the concurrent audit procedure had been in effect **at least \$42 million could have been recovered by the end of the fiscal year, and the amount repaid could possibly be much higher.** The State of California is losing the use of this money at present, and if nothing else would be receiving a substantial sum in interest income.

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Additionally, we believe that full federal reimbursement is not being received by the Division of Highways for the following reasons:

- (1) By the failure to include all eligible project costs in the reimbursement claims submitted to the Federal Bureau of Public Roads;
- (2) By the failure to include all types of eligible costs in reimbursement claims;
- (3) By the failure of the accounting system to identify and separately accumulate eligible costs; and
- (4) By exceptions taken to amounts claimed from the Federal Bureau of Public Roads due to lack of proper documentation or other causes.

It is impracticable for the Auditor General's staff to undertake a detailed analysis of amounts lost to the state by accounting deficiencies of the Division of Highways. In some instances specific amounts have been developed, but a complete analysis would require a detailed study of voluminous records covering several years of operations. Their findings, however, are based on tests sufficient in size and scope to demonstrate the point that deficiencies in the records or procedures have resulted in the loss of federal funds.

Three such examples due to failure to include all eligible project costs were reported to us by the Office of the Auditor General on March 2, 1965. The review consisted of a test of the recovery claims filed, and therefore could not reveal the total losses involved. But the examples cited **resulted in a loss of approximately \$100,000.**

In 1962, federal regulations were changed to permit the reimbursement of the state's costs of auditing utility and contractor records. In 1964, the Auditor General's staff found that although the Division of Highways was recovering utility relocation auditing costs no steps had been taken to recover the costs of auditing contractors' records. The loss which occurred between the time of the change in federal regulations and the time the division began to claim reimbursement **was approximately \$100,000.** We are advised this loss cannot be recovered.

Prior to July 1, 1966, engineering supplies at District 7 (Los Angeles) were neither included in the inventory nor charged to projects as used. The result was that these

costs were not eligible for federal reimbursement. This loss appears to have been **approximately another \$100,000** during the 1965-66 fiscal year.

Recently we recommended that the division record depreciation of buildings and equipment in the accounting system. Federal reimbursement would be increased as a result of this change, and the recommendation is presently under study by the Division of Highways.

On March 2, 1965, the Auditor General's Office advised us that some eligible design costs were not being recovered from the federal government due to failure to identify and relate all design projects to resulting construction work. We informed accounting personnel of the division that at least six federal projects did not include design costs, and copies of the staff auditor's working papers were given to division accountants for their use. We suggested to the accounting personnel that in the future they make it a practice to consult with engineering personnel responsible for design before preparing federal claims.

We have recently established that the division did resubmit revised federal claims for two of the six projects mentioned above. **The increased claims totaled \$209,600.**

However, during our current review the Auditor General's staff found that division accounting personnel **still have not** made it a practice to consult with design engineering personnel to determine whether all possible costs have been included in final claims for federal recovery.

In the course of the review we found that on occasion accounts receivable from the federal government have been written off the records by the same division personnel responsible for preparing federal claims. In addition, we found that this is being done without management approval.

A case in point is federal project I-005W-6(23)508. A claim in the amount of \$382,300 was filed with the Federal Bureau of Public Roads in September 1964. This claim was disallowed by the bureau, and then canceled in the accounting records of the State Highway Fund. Management approval was not obtained for the writeoff.

We discussed the circumstances of this claim with a representative of the Federal Bureau of Public Roads. The bureau agreed with us that all or part of the \$382,300

**should be recovered.**

The matter has been referred to the accounting personnel who are in process of reviewing it.

In addition to the study of division claims, on August 8, 1966, the State Highway Fund bureau refused payment of \$1,561,000 of this disputed amount.

Division agreed with us and will not press the claim. Additional data submitted. Under further study.

Total -----

In our opinion, the division has written off \$4,000,000 without further explanation. We state it should not be written off if this amount is determined to be a loss. It illustrates the weakness of the system.

The division review work done for other projects is an analysis and is extremely limited. It is not our recommendation; it is only a theory but with no further study. We consider it unacceptable, and we recommend further study in accounting procedures and recommendations.

#### **(b) Right-of-way rent**

Due to the long-term construction program, the State Highway Fund has been forced to buy land and even years, but the method of reimbursement involved the division of properties, thus placing a burden on the landlord. Although the State Highway Fund has a financial benefit to the State,

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should be recoverable by the State Division of Highways. The matter has been brought to the attention of division accounting personnel, and as a result of our urging they are in process of resubmitting the claim.

In addition to the federal claim mentioned above, a study of division records for the period July 26, 1965-August 8, 1966 shows that for various reasons the federal bureau refused payment of reimbursement claims in the amount of \$1,561,052. As of September 13, 1966, the status of this disputed amount was as follows:

Division agreed with bureau findings, and will not press further claims -----	\$493,902
Additional data submitted for bureau consideration --	344,945
Under further study by division -----	722,205
Total -----	\$1,561,052

In our opinion, the fact that the Division of Highways has written off \$493,902 of federal funds **demands some further explanation.** If this amount was not due to the state it should not have been claimed. On the other hand, if this amount is due the state but cannot be substantiated it illustrates the shortcomings of the present accounting system.

The division replied to our report on accounting for work done for others. The reply is a very lengthy, detailed analysis and is extremely defensive in tone. The majority of our recommendations are either rejected; only partially accepted; not directly responded to; agreed to in theory but with no change proposed; or are to be given further study. We consider this reply to be inconclusive and unacceptable, and we shall continue to seek improvements in accounting procedures and controls in line with our recommendations.

**(b) Right-of-way rental accounts receivable:**

Due to the long-range nature of freeway and highway construction programs, the Division of Highways has been forced to buy properties along rights-of-way months, and even years, before construction can begin. As a method of reimbursing the state for part of the costs involved the division has permitted tenants to rent these properties, thus placing the division in the role of the landlord. Although the program has been of some financial benefit to the state, it has also created many problems.

In 1961 a major revision was made in the rental accounting system of District 7 (Los Angeles). Under this revision a part of the recordkeeping process was transferred to computer operations, but from this time on the detail records have not been in agreement with the control records. Although the records were **out of balance for four years** little or no effort was made to reestablish proper controls.

During the four-year period, reports were submitted to headquarters indicating that the accounts receivable records were in balance and under appropriate control although district accounting personnel knew this was not the case.

The Joint Audit Committee was notified of this finding by the Auditor General's staff in March 1965, and appropriate personnel of the division were made aware of the situation at that time. A task force was assigned by the division to review the records of the four-year period with instructions to correct and reconcile the errors involved, and to revise the system to prevent any recurrence. The work is still in progress.

It is general practice in the division's rental operations to permit tenants to have maintenance and repair work performed, and to deduct the cost of such work from rent payments. In our opinion, this practice constitutes disbursement of state funds for work on state-owned property.

Under the method employed, costs of repairs and maintenance deducted from rent remittances are recorded as reduced revenue. Therefore, these costs are not subject to the budget process—the primary control over public expenditures.

It is generally required that expenditures be specifically authorized in writing before costs are incurred, but this has not been followed in many cases. In fact, we know of no other type of state expenditures whereby such informal methods are permitted.

In our report on this subject, a number of specific cases were cited to show poor and inefficient handling of tenants' repair and maintenance costs. In addition, by allowing deductions from rent both revenues and expenditures have been understated.

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For example, in a cited case of plumbing repairs and allowance for household carpeting almost **an entire year's rent income** on one property was not reported. Additionally, a Long Beach tenant **twice** was permitted to deduct from rent the cost of the same water closet, and a Sacramento tenant was allowed **both** a \$35-per-month rent deduction for taking care of a swimming pool and a \$58 deduction for the professional cleaning of the same pool.

If this system is to be employed, it should be established before a rent reduction is authorized that the supplier or contractor involved has been paid. In one Los Angeles case, a tenant was allowed to deduct \$155 from rent to pay for new tile in the shower. After the tenant had vacated, the **contractor submitted a bill to the Division of Highways.**

The state claimed it was not a party to the above contract between the former tenant and the contractor. This may be true, but the fact remains that a tenant was permitted an improper deduction from rent and a contractor apparently remains unpaid for an improvement to a state-owned building.

Section 104.6 of the Streets and Highways Code requires that 24 percent of the rent from right-of-way properties is to be deposited in the Highway Properties Rental Fund for distribution to the counties. The counties have not received their full share of this rental income, because it has been the practice to transfer to the fund only **24 percent of the cash received** rather than 24 percent of the gross rent.

On the other hand, some utility services are paid by the Division of Highways with repayment later from tenants. These utility reimbursements have been included with rent payment in the fund, and as a result counties have been overpaid.

Due to our reports, revised procedures for handling right-of-way properties were instituted by the division and became effective July 1, 1966. However, the out-of-balance condition existing prior to July 1, 1966, is not yet resolved, and approximately **\$57,000 of unexplained difference remains.**

The examination of the State Highway Fund also showed that **Los Angeles County had been underpaid approximately \$500,000** over a three-year period from its

share of right-of-way rental receipts. Correction of the records has now been made, and Los Angeles County has been paid.

Rent from property acquired for the interstate highway system is exempt from normal requirements. This exemption is necessary because approximately 91 percent of the rent revenue must be paid to the federal government. During the 1960-61 fiscal year **Sacramento County was overpaid \$67,000** because rent from interstate highway property was erroneously included in the distribution to the county. As a result, rental income must be adjusted for several years into the future before correction is complete.

We recommended to the Division of Highways that regular prescribed state disbursing procedures be adopted for the handling of repairs and maintenance on right-of-way properties. This recommendation was rejected by the division.

However, following the arrest and conviction of a division right-of-way agent for the embezzlement of rental income, we suggested this matter be given reconsideration. The Department of Public Works has responded and indicated that additional study is now being given to improving these controls.

Two different methods have been employed in the past to account for right-of-way rental accounts receivable. One method is the accrual basis, while the other is on a cash basis. We have suggested to the Division of Highways that all rental accounts be on the accrual basis, and this suggestion has been accepted.

#### REPORT NO. 2 — REVIEW OF INVENTORIES

There are major deficiencies in recordkeeping and management of inventories within the Division of Highways. Substantial quantities of materials are on hand at all times for which no inventory records are kept. The costs of such materials are recorded as expenditures when incurred, although a considerable period of time may elapse before the materials are used.

Major differences exist between division locations as to items included in inventory; records maintained; documents used to record inventory transactions; and the physical controls over such inventories.

For the most part, the inventory location policies and procedures are being kept, maintained, and advanced of modern methods.

At some locations, items of value are not inventoried, only part of the rent, or in the controls are in place.

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For the most part, personnel at each of more than 200 inventory locations have been free to establish their own policies and procedures for ordering, receiving, record-keeping, maintaining, and issuing materials acquired in advance of needs.

At some locations inventory records are kept for all items of value. At others, records are maintained for only part of the materials on hand, records are not current, or in balance with control records, and physical controls are inadequate.

In 1962, at a cost of approximately \$200,000, a consulting firm was employed to study computer applications within the Division of Highways. The study produced 13 reports, one of which was entitled "Recommendations to Reduce Excessive Supply Inventories and Improve Service." The private consulting firm estimated that there was **twice** as much dollar value of unrecorded inventory as there was of recorded inventory. In any event, there has been little improvement to date.

The division *Accounting Manual* specifies that district offices shall maintain detail records for each inventory location. However, District 3 (Marysville) and District 7 (Los Angeles) did not maintain such records.

Failure to include engineering supplies in the inventory, and failure to charge the cost of materials to projects on the basis of withdrawals has resulted in the **loss of federal reimbursement**. In addition, loss has resulted from failure to include salvaged materials in the inventory records.

Traffic signal devices and component parts constitute one of the largest dollar items omitted from inventory records. Signal controllers may cost up to \$3,000 each, with an average cost between \$1,000 and \$2,000.

Recently, we have been advised by accounting personnel of District 4 (San Francisco) that dollar value of **unrecorded inventory** now being processed **will be approximately \$300,000**. Of this amount, approximately \$200,000 represents the value of traffic signal devices.

With this report we included a total of eight recommendations for improvement in recordkeeping and management of inventories. The Division of Highways published a 25-page reply, but did agree to implement each of the eight recommendations made. As a result, we

believe little can be gained from further discussion of this problem area at present, but we do look forward to considerable improvement in the future.

**REPORT NO. 3 — LIMITATION OF EXPENDITURES FOR  
GENERAL ADMINISTRATION AND MAINTENANCE**

(Section 186, Streets and Highways Code)

The Division of Highways expenditures for general administration and maintenance cannot exceed, by law, the revenue derived from one-cent-per-gallon of the tax on motor fuel.

The Streets and Highways Code was amended in 1957 to exclude the cost of toll bridge maintenance from this provision, and in 1963 further amendment excluded maintenance costs of all landscaping and functional planting on state highways.

In the Auditor General's review of this subject, we found that the term "general administration" is not defined in the statutes, and the division places some charges of an administrative nature under other expenditure classifications.

We believe the following statement formulated by the American Association of State Highway Officials, and included in their manual of uniform highway accounting procedures, provides a sound basis for determining the cost of administration:

"Administrative costs include all costs of a Highway Department, in the central or district offices, which are of a general nature and not incurred directly on or for a specific construction project, or maintenance or control section, or other function separately recognized or financed. Such costs include the salary and expense of the Highway Department's governing body and of employees engaged in a general administrative, guidance, or supervisory capacity, or furnishing general services such as accounting, budgeting, auditing, legal, personnel, stenographic, filing, purchasing, mailing and public information. They also include the general expense of the central and district offices such as rental and maintenance of buildings and grounds, telephone, lighting, heating, and office equipment and supplies."

Although rental costs and operation of office buildings, including utility costs, are legitimate administrative expenses they are charged to the various division activities

on the basis applicable to administrative units. Supplies are also various units.

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on the basis of square feet occupied. Thus, only costs applicable to those parts of buildings occupied by administrative units are classified as administrative costs. Supplies are also charged on the basis of actual usage by the various units.

All nonsalary payroll expenses (fringe benefits) are legitimate administrative costs, but only those applicable to certain designated "administrative salaries" are classified in this way.

Clerical staff salaries and expenses are legitimate administrative costs. However, salaries of clerical workers in maintenance units are classified as a cost of maintenance, and salaries of clerical workers in right-of-way units are classified as a cost of right-of-way. As a result, substantial amounts of administrative costs are recorded under other classifications.

We do not believe any natural relationship exists between the revenue derived from one cent of the tax per gallon on motor fuel, and the rate of expenditure necessary to administer and maintain the highway program and state highways.

The present formula complicates the accounting system, and makes it all but impossible to establish the actual cost of administration and maintenance. In addition, with these charges carried over into other classifications the costs of engineering and such like programs are inflated and do not present an actual picture of their costs to the state.

We have recommended that a study be conducted to resolve this problem. The Division of Highways has agreed to cooperate with such a study, but so far has shown little interest in initiating it themselves.

#### REPORT NO. 4 - PERSONAL SERVICES TRANSACTIONS

During the course of the examination of the State Highway Fund, members of the Auditor General's staff completed a review of personnel records at several district offices of the Division of Highways. Two reports were issued containing 33 recommendations for improvements in procedures, and we believe that immediate corrections should be made by the personnel and accounting departments involved.

At most division district offices employees working time is reported on two documents. First, a monthly staff time sheet is prepared by each employee and this is an EDP (electronic data processing) input document for distribution of all staff payroll costs. Additionally, an employee in each payroll reporting unit or subdivision has responsibility for maintaining a staff attendance record.

Although there is variation in forms utilized, the latter record is the basis for monthly payroll reporting to the State Controller and for maintaining employee leave records within district personnel departments.

However, at District 11 (San Diego) the only record of attendance is the monthly time sheet prepared by each employee. This time sheet is used for all the purposes described above, and though it is approved by supervisors such approval has little significance if employee attendance records are not kept. In fact, accuracy of payroll reporting becomes dependent upon the memory and integrity of each individual employee.

At District 7 (Los Angeles) the accounting department does not account for staff time sheets, and as a result there is no assurance that all such documents are recorded in the accounting system. The accounting department relies on individual payroll reporting units to determine that a time sheet is received and transmitted, but we believe this should be the accounting department's responsibility.

Also, at District 7 no comparison is made between time sheets and payroll warrant registers. Most districts make this comparison to ensure all time sheets are received, and to determine that the same information is used to account for labor costs in the accounting system.

Due to the time allowed for processing accounting information, it is common practice for field personnel in the engineering services department of District 7 to prepare and submit time sheets prior to the end of the month. However, working time reported is carried through the end of the month. Therefore, both staff time sheets and monthly attendance reports contain information supplied in advance of the actual days worked.

In an effort to reduce changes requiring corrective action, field personnel are instructed to inform the dis-

trict office by schedule. With many changes

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trict office by telephone of any changes in the working schedule. With such an informal procedure, however, many changes are never made on the records.

The review of December 1965 revealed that the personnel department had received information on about one-half of the changes occurring, while the accounting department had received no notice whatsoever.

We have recommended that the practice of preparing staff time sheets and attendance records in advance of days worked be discontinued, and such information be supplied only after the end of the reporting period.

In addition to the changes made on attendance reports, it is frequently necessary for personnel departments to make changes in classification of absences due to insufficient balances in accrued vacation, sick leave, and overtime earned. When an insufficient balance exists the personnel department at District 7 changes the attendance report and notifies the payroll reporting unit by telephone. The reporting unit then informs the employee and prepares a corrected time sheet for the accounting department.

The review showed that corrected time sheets had not been received by the accounting department for all such changes. The telephone is a rapid method of communication, but leaves no record of the message being received by appropriate personnel. We have recommended that when a payroll reporting unit makes a change in time sheet information a copy of the memorandum be sent to the accounting department. In the same manner, when the personnel department makes a change in attendance records the accounting department should be notified in writing.

The Auditor General's inspection at District 7 revealed that although staff timesheets and foremen's daily reports are compared with travel expense claims, this comparison is to establish that employees are only claiming travel expense for days actually worked. Because of this limitation we found many of the following inconsistencies:

- (a). Different expenditure authorizations and general ledger accounts charged.
- (b). Inconsistent federal aid eligibility codes used, and
- (c). Different organizational units charged.

When items (a) and (b) are applicable to a federal aid project, the amount of **federal recovery claimed will be incorrect**. We believe the comparison should include a review to determine that coding is consistent.

In District 4 and District 7 car tags (vehicle usage reports) are not compared with either travel expense claims or staff timesheets. As a consequence, the same types of inconsistencies and differences described above were found, and the **same errors occur in federal reimbursement claims**.

The processing of sick leave absence requests for division personnel leaves much to be desired. While not typical, the following transactions show that little reliance can be placed on the records.

The attendance report and staff timesheet for one District 7 employee shows he was granted sick leave for the period August 26-27, 1965. An absence request for those dates reports the employee at home with a "bad cold." The request is dated August 30, 1965 and is signed by both the employee and his supervisor. The employee's sick leave balance was reduced by two days in the leave record.

However, an unsigned and undated correction memorandum reporting the employee as working on the dates involved was received by the district personnel department on February 18, 1966. On the basis of this memorandum the accounting records were changed. Thus, although the timesheet, attendance report, absence request, and leave record all agree that the employee was on sick leave; almost six months later the records were changed to show the employee as working.

The timesheet and attendance report for another employee of the same payroll reporting unit shows this employee on vacation for the entire week of August 27, 1965. However, the same undated and unsigned correction memorandum described above was used to change the record to show this employee as working the week in question, and to restore 40 hours to his earned vacation balance.

Division of Highways personnel absent for jury duty are required to submit an absence request form in duplicate. One copy of this form is sent to the personnel department, and one to the accounting department. The

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review at District 7 disclosed many instances where only one of the two departments received an absence request, and instances where neither department received the request.

A District 7 accounting department employee responsible for processing timesheets, included on her February 1966 jury duty absence request only those periods for which she thought a court fee would be paid. The attendance report therefore was in error by showing the employee as not absent, and the only indication of absence is contained in the staff timesheet. If an accounting department employee is unaware of correct procedures it is safe to assume that other employees also are unaware of these requirements.

Jury duty fees received by employees are remitted to the Division of Highways. However, as of March 1, 1966, no action had been taken to determine whether jury duty fees for 19 absences taken during the period July 1, 1965-January 31, 1966, were remitted to the division.

Within the division there is no proper procedure to account for these jury duty absences, and no procedure to determine whether amounts of jury duty fees remitted are correct. Employees can be on jury duty under three conditions: (1) for examination and registration, (2) for impanelment, and (3) for service on a jury. Variation exists among courts as to which of these circumstances are subject to payment, and differences exist in amounts paid.

To establish proper control over jury duty absences and over amounts due the state from this service we have made a number of recommendations to the Division of Highways.

Student trainees employed by the division in District 4 are continued on the payroll records after returning to school. We were informed the reason for this practice is to simplify recordkeeping in case the trainee returns to work during Christmas vacation or the following summer.

While this procedure may result in less paperwork, it also creates an internal control problem. Attendance clerks in the various payroll reporting units frequently receive and distribute payroll warrants. It would be possible for these clerks to include fictitious hours worked by trainees on attendance reports, and to receive the war-

rants issued by the State Controller. We have recommended that summer student trainees be separated from state service and removed from payroll records upon their return to school.

State Personnel Board Rule 131, which is incorporated into Division of Highways circular letter 64-290, provides that overtime for most employees must be authorized in advance except in cases of emergency. In both District 4 and District 7 advance authorizations have not been obtained for all overtime worked.

At District 4 a major part of the overtime worked by construction employees was not authorized, and at District 7 various departments have not obtained approval for overtime worked.

The accounting department, the personnel department, and each of the departments in District 7 receiving overtime authorizations maintain records of overtime approved and overtime worked. For the quarter ending December 1965, the three sets of records were in agreement for only one department out of the 24 receiving such authorizations.

Differences exist between accounting department records and the other two sets because the former are maintained on a calendar month basis, while the latter are maintained on the basis of the State Controller's pay periods. However, there should be no difference between the personnel department records and the records maintained by the individual departments. We have recommended that this situation be corrected.

It has been the practice at District 7 to require personnel of the communications department to submit a signed blank timesheet at the beginning of each month for completion by the supervisor at the end of the month. This practice gave rise to a charge by an employee that timesheets in all cases did not reflect the actual time worked.

We have been advised that the practice has been discontinued in this particular department, but the review reveals other instances of time sheets being prepared by someone other than the employee concerned. We believe that all employees should complete their own timesheets.

This subject has been stressed because the monthly staff timesheet is a basic input document in the account-

ing system. A summary of ways expenditure and a significant basis. The staff timesheet, a staff employee, and but other accounting claims.

In an organization, instructions should be given, and use of a timesheet. Many of these exist because such

Preparation of a period covered has specify that timesheet end of the reporting the District 7 accounting have been received no instructions received

Personnel of the blank timesheets on the subject, a copy differs among the copies would stand would have an audit sheets.

At present, the records is made by staff. At the request supplied him with a program covering personnel internal accounting continuing review with this plan for

- (a) The responsible accurate records should have the records
- (b) District records time, and travel expenses
- (c) Continuous result in management

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ways expenditures are accounted for by these documents,  
and a significant amount of federal aid is received on this  
basis. The staff timesheet is the personal report of each  
staff employee, and it affects not only personnel records  
but other accounting documents such as travel expense  
claims.

In an organization the size of the division detailed in-  
structions should be provided for the preparation, distri-  
bution, and use of the various copies of the staff time  
sheet. Many of the deficiencies and weaknesses noted  
exist because such instructions are not provided.

Preparation and submission of timesheets ahead of the  
period covered has been accepted because no instructions  
specify that timesheets are to be prepared only after the  
end of the reporting period. No determination is made by  
the District 7 accounting department that all timesheets  
have been received and entered into the system because  
no instructions require this determination.

Personnel of the communications department signed  
blank timesheets because instructions were not provided  
on the subject, and distribution and use of the various  
copies differs among the districts. Divisionwide instruc-  
tions would standardize procedures, and all employees  
would have an authoritative basis for preparation of time-  
sheets.

At present, the only internal review of district personnel  
records is made by Transportation Agency internal audit  
staff. At the request of the District 4 fiscal officer we have  
supplied him with a copy of the Auditor General's pro-  
gram covering personal services. Plans are to expand the  
internal accounting review within District 4 to include a  
continuing review of personnel records. We are in accord  
with this plan for the following reasons:

- (a) The responsibility for providing complete and ac-  
curate record rests with the districts. The districts  
should have ability to determine the condition of  
the records.
- (b) District reviews should result in reduced audit  
time, and should produce savings in such areas as  
travel expense, etc.
- (c) Continuous review of current transactions should  
result in more reliable records.

As of June 30, 1966 the actual liability for vacation earned but not taken was approximately \$10 million in excess of the recorded liability. The primary cause of this understatement is that vacation expense is based on the current year's cost, and is measured by vacation time taken. No recognition is given to the fact that salary increases also increase the liability for vacation earned but not taken.

Many employees carry forward from year to year approximately the same number of earned vacation days, and, as salaries increase the state's liability for these earned vacation days also increases.

A new employee may accumulate and maintain a balance of earned vacation, and the state's liability is based on the salary in effect at the time the vacation is earned. However, when the employee subsequently takes this vacation time, terminates from state service, or is retired the cost to the state is based on the salary rate in effect at the time the vacation is used. Consequently, vacation cost is substantially higher in many cases than the provisions made for it.

The difference between recorded and actual liability of approximately \$10 million is the result of failure to recognize total costs of vacation credits granted to employees. A further result is that the aggregate cost of State Highway Fund operations has been understated over the years, and this is also true for the cost of projects completed. In other words, approximately \$10 million in costs have not been charged to projects by the State Highway Fund, and an accrued liability for these costs is not recorded in the accounts.

An immediate adjustment of the records in the amount of \$10 million would not be a practicable solution. Therefore, we have recommended that the vacation portion of the nonsalary payroll expense rate be established at a level to provide for the full current cost of vacation, plus a factor to pick up the unrecorded costs of previous years. If necessary, this could be spread over a 10-year period.

We recognize that this solution does not provide complete equity. Projects now closed which were charged less than an equitable share of vacation costs would not be corrected, and future projects would be charged more than an equitable share of these costs. However, this solu-

tion would minimize this late date,

During the payment of financial actual liability expense rate full liability be selected.

#### REPORT N

As part of the Auditor General completed contract District 4 (State that overpayment the contracts the state of \$2

These overpayment language contained in the Standard Specification

"... such findings are conclusive and binding on all parties and the contractor

In 1962, Auditor General suggested to the Department of Highway Construction that permit recovery of computing payment by the State 27, 1962.

Following the standard specification for the country, project to determine if there is overpayment quantities.

The survey have such a project instead, in 24 of standard specification recovery of sum

Following is the standard specification

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tion would minimize the distortion in trying to adjust, at this late date, the understatement in the vacation accrual.

During the period of adjustment a footnote to the statement of financial condition should continue to disclose the actual liability, and describe that the nonsalary payroll expense rate includes a factor which will result in the full liability being recognized and recorded by the date selected.

#### REPORT NO. 5—OVERPAYMENTS TO CONTRACTORS

As part of our 1966 audit of the State Highway Fund, the Auditor General's staff examined the records of seven completed construction contracts in Division of Highways District 4 (San Francisco). The examination revealed that **overpayments** were made to contractors in **three of the contracts studied**, and this has resulted in a loss to the state of **\$2,647.41**.

These overpayments cannot be recovered due to the language contained in Section 9-1.07B of the 1964 *Standard Specifications*. This section reads:

"... such final estimate and payment thereon shall be conclusive and binding against both parties to the contract on all questions relating to the amount of work done and the compensation payable therefor. . ."

In 1962, Audits Division of the Department of Finance suggested to the Division of Highways in interim letter DII-C-11 that the *Standard Specifications* be modified to permit recovery of overpayments resulting from errors in computing pay quantities. This suggestion was rejected by the State Highway Engineer in a letter dated June 27, 1962.

Following up on this problem, we have reviewed the standard specifications of 25 governmental agencies across the country, principally other state highway departments, to determine if it is common practice to prevent recovery of overpayments resulting from errors in computing pay quantities.

The survey showed that **none of the agencies checked** have such a provision in their standard specifications. Instead, in 24 of the 25 governmental agencies reviewed the standard specifications **contain sections providing for the recovery of such overpayments**.

Following is an example of the language contained in the standard specifications of another state:

**Connecticut Standard Specifications Section 1.07.16**

"The Commission reserves the right, should an error be discovered in the estimate, or conclusive proofs of defective work or materials used by or on the part of the Contractor be discovered, either before or after the acceptance of a contract, or even after the final payment has been made, to claim and recover by process of law such sums as may be sufficient to correct the error or make good the defects in the work and materials."

With only minor exceptions, the wording of other standard specifications reviewed is the same or similar to that of the State of Colorado. Which states:

**Colorado Standard Specifications Section 7.16.1**

"The Department or the Engineer shall not be precluded or estopped by any measurement, estimate or certificate, made or given by either them or by any agent or employee of the Department, under any provision or provisions of the Contract, at any time, either before or after the completion and acceptance of the work and payment thereof pursuant to any measurement, estimate or certificate, from showing the true and correct amount and character of the work performed and materials furnished by the Contractor, or from showing at any time that any measurement, estimate or certificate is untrue or incorrectly made in any particular . . ."

The former Administrator of the Transportation Agency, Robert B. Bradford, replied to our report on this subject on December 20, 1966. In his letter to the Joint Audit Committee, Mr. Bradford states the following:

"State business should be conducted in accordance with sound business practices. Such practices, in my judgment, include a final settlement of the contract which is binding on both parties and which is made as soon as practicable. It is my feeling that Section 9-1.07B achieves this objective, and in so doing is in the best interest of the State. However, representatives of the Division of Highways would welcome discussion of the matter with Mr. Merrifield (Auditor General) if it can be shown that there is a problem of sufficient magnitude to warrant consideration of a change."

We entirely agree with Mr. Bradford that "state business should be conducted in accordance with sound business

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ness practices.” However, we do not believe Section 9-1.07B of the *Standard Specifications* constitutes sound business practice. Furthermore, we cannot agree that this practice “is in the best interest of the state.”

The standard specifications of 24 out of 25 other governmental agencies provide for repayments from contractors. By specifically preventing such action the State of California stands alone, and we cannot understand the division’s insistence on this policy.

A test sample of seven completed construction contracts cannot be used as a basis for making comparisons or projecting percentages. But it is clear that when three contracts out of seven show evidence of overpayments this problem is serious and requires correction.

We recommend that Section 9-1.07B of the California *Standard Specifications* be removed, and a new section permitting recovery of overpayments be included. We further recommend that until such amendment is made the special provisions of each contract be modified to include a statement that Section 9-1.07B is not applicable.

#### CONCLUSION

The expenditures of the State Highway Fund approximate \$1 billion for the 1965-66 fiscal year. This figure is a significant portion of the total funds administered by the California state government.

In our *Biennial Report* of two years ago, it was pointed out that the State Division of Highways did not have an acceptable accounting system. The reports submitted to your joint committee by the Auditor General in recent months show no material improvement in this regard.

The joint committee believes that this agency, handling hundreds of millions of dollars each year, should have long since established accounting and reporting techniques which are above reproach. However, this has not been accomplished.

As a result, your joint committee believes the Legislature should make a complete study of the management structure and accounting capabilities within this important highway agency. We trust such a study can be made in the near future.

## **CHAPTER FOUR**

### **RESOURCES AGENCY--DEPARTMENT OF WATER RESOURCES**

The Department of Water Resources presents one of the most serious accounting problems in California state government. This situation dates back to the establishment of the department in 1956. No attempt was made at that time by the Department of Finance to assess the nature of the difficulties, and no adequate accounting system was instituted.

Although much effort has been expended in recent years in attempts to improve accounting procedures and methods, due to the lack of qualified accounting personnel the department has not been able to recover from its poor beginning.

Because of deficiencies noted during the Auditor General's 1964 examination of the department, we issued a special report entitled "Survey of the Accounting Function of the Department of Water Resources." This report was dated August 11, 1965, and contained the following recommendations:

1. The accounting system needs to be simplified.
2. The financial statements need to be redesigned.
3. The reconciliations need to be improved.
4. The accounting manual needs to be brought up to date and improved.
5. The accounting section needs to be strengthened.
6. The accounting staff needs to be better trained and supervised.
7. The accounting for certain relatively small programs needs to be simplified.
8. Better internal controls over accounting data need to be established.
9. The automatic data processing service center needs to be equipped and staffed to handle the department's accounting requirements on a current basis.

As a result of the special report and the recommendations outlined above, the Director of the Department of Water Resources appointed a task force to improve the



accounting system, procedures, and operations within the department. The task force is headed by a systems analyst from the Department of General Services, and has representatives from the internal audit office of the Department of Water Resources and Audits Division of the Department of Finance.

In addition to the task force, a national accounting firm has been retained to assist in the improvement of the accounting system. Both the task force and the private consultants supplied by the accounting firm report to the comptroller of the department.

The task force was organized in October 1965, and the private consultants began work in January 1966. Consequently, their activities had no effect on the department's financial statements for the year ending June 30, 1965, which have been examined. However, they have been informed of our findings, and have taken them into consideration.

The Water Resources Revolving Fund is the primary operating fund of the Department of Water Resources. The Auditor General's staff have examined the statement of financial condition of this fund, and the related statement of operations for the year ending June 30, 1965.

The statement of operations does not correctly present the results of operations for the year. It does not analyze the changes in fund balance as it purports to do, nor is it stated on a basis consistent with that of the preceding year.

The department attempted to adjust accounts at year end to an accrual basis from the hybrid basis used during current and preceding years. This was not completely done, so some accounts are misstated on an accrual basis and are inconsistent with the presentation of the previous year. Following are some of the discrepancies in the accounts:

- (a) Operating income (capital outlay) is overstated by \$829,000.
- (b) Operating expenses — capital outlay and contract retentions are overstated in total by \$645,000.
- (c) Transfers from other funds are understated on the accrual basis by approximately \$1 million.
- (d) Expenditures chargeable to other funds — support is understated by approximately \$5.4 million, be-

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cause accounts payable accrue at June 30, 1965. Increase in liability for vacations and depreciation expense were not included.

(e) A net decrease in assets of \$660,385 is included in the statement to make it balance. This figure has no relationship to the change in net assets for the year, nor is it supported by any account on the books of the fund.

Work in progress accounts in the amount of \$120,273,435 include approximately \$115 million of accumulated costs which no longer represent assets of the fund. They have been billed and collected, but are not so shown in the statement.

The balance of the work in progress represents amounts due from other funds and agencies. A comparison of the detail supporting the work in progress accounts and the accountability accounts indicates that these accounts are understated by approximately \$4.8 million.

Because of the materiality of the exceptions noted above, the statement of financial condition and statement of operations do not fairly present the financial position of the Water Resources Revolving Fund for the year under review. The Auditor General issued a similar opinion regarding the financial statements of the fund for the year ending June 30, 1964.

During the course of this audit the Auditor General's staff were in constant communication with members of the task force and the outside private consultant. Findings were discussed with them as the work progressed.

The task force and the representatives of the private consultant are expected to continue their operations at least until the summer of 1967. We hope by that time they will have succeeded in resolving the problems of the department, and will have brought the accounting up to a current basis.

In any event, we strongly recommend that the Department of Water Resources continue to retain the private consultant and task force until such time as the new system is fully implemented, documented, and operating smoothly with personnel instructed and trained.

## CHAPTER FIVE

### STATE TEACHERS' RETIREMENT SYSTEM

The major retirement systems administered by the State of California are (1) the State Teachers' Retirement System and (2) the State Employees' Retirement System. These two systems are financed under totally different plans.

The state's annual contributions to the State Employees' Retirement System are set at a level sufficient to provide and maintain the assets of the system. Assets at a given date will be approximately equal to the value of accrued benefits on that date, and the cost of benefits are provided for as services are performed.

The term "actuarial soundness" can have various meanings. It ranges from having a fully funded retirement plan sufficient to pay all benefits accruing on any given date, to having a retirement plan with resources sufficient only to pay future benefits of members in a retired status.

At present, the state is required to make annual contributions to the State Teachers' Retirement System in amounts equal to the difference between benefits payable and that portion of the benefits provided by member and employing agency contributions.

Thus, the State Teachers' Retirement System **does not meet** even the least stringent meaning of the term "actuarial soundness."

By statute, the state is required to make sufficient annual contributions as may be needed to meet guaranteed benefits. We do not believe this is sound business practice for meeting the accruing cost of teachers' pensions, and the state's contribution has climbed from \$20.6 million in the 1956-57 fiscal year to \$59.7 million in the 1965-66 fiscal year.

The actuarial balance sheet as of June 30, 1964, showed the value of the contributions to be made after this date to provide for benefits presently granted, or to be granted, under provisions of the State Teachers' Retirement Law. The required contributions are as follows:

Members -----	\$979,556,000
Employers -----	448,955,000
State -----	2,851,341,000

For the first time, the actuarial balance sheet at June 30, 1964, did indicate the value of state liability for services already performed. However, the report on the actuarial investigation did not include a schedule of annual contributions required to liquidate the state's obligation over a specified period of time.

In our opinion, the preparation of an actuarial balance sheet without such information materially decreases the value of the investigation.

An examination of the accounts and records of the State Teachers' Retirement System was begun by members of the Auditor General's staff in October 1962. At this time, the books for the year ending June 30, 1962, had not been closed, and were still not closed when the staff auditors withdrew from the agency in July 1963.

In addition to accounting records not being up to date, the auditors found that the accounting system did not provide necessary controls and means of accurate, timely reporting of financial information. In order to complete their examination and report on the financial condition of the system the Auditor General's staff would have been compelled to resume their work after a further lapse of time, and do an inordinate amount of detail verification of accounts, especially those for members' contributions.

However, during the course of this audit the State Teachers' Retirement Board requested the systems analysis unit of the Department of General Services to make another study of the system. In order to avoid a duplication of work the Auditor General curtailed certain portions of his examination.

Due to the condition of the records, the Auditor General was unable to report on the financial statements of the State Teachers' Retirement System as of June 30, 1962. In March 1964 he did issue a report on the deficiencies found in the accounting records of the system, and on the financial and management problems involved.

On August 18, 1964, as a result of this report, the Auditor General was asked to appear before a meeting of the Joint Legislative Retirement Committee and testify on the problems found in the system.

This led to another meeting of the Joint Retirement Committee on April 7, 1965, at which time the scope and cost of a management survey of the system was discussed,

and groundwork by Concurrent Session).

At the request of the Auditor General to ascertain the status of his report the Auditor General hired a national firm of accountants to make a management survey.

In October 1964 the Joint Retirement Committee adopted a Proposal to Comprehensively Alter the State Teachers' Retirement System, which was being implemented by the Auditor General with representatives of the State Teachers' Retirement Board.

In December 1964 the firm of Peat, Marwick, Main & Co. was engaged to conduct a management survey process.

We do not believe that the system should exist in its present form. The State of California should provide for the retirement of service at the time of retirement. Two of the recommendations of this subject, dated June 30, 1964, are:

- (1) We recommend that the annual contribution of time to the State Teachers' Retirement System be increased to the level of the State Teachers' Retirement System as the State Teachers' Retirement System.
- (2) We recommend that the State Teachers' Retirement System be actuarially sound to fully fund the system to provide for the retirement of the system to fund or to fund from the State Teachers' Retirement System.

In the report of the Joint Retirement Committee recommended that the State Teachers' Retirement System be actuarially sound to fully fund the system to provide for the retirement of the system to fund or to fund from the State Teachers' Retirement System.

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Session).

At the request of the Joint Retirement Committee, the  
Auditor General's staff again inspected the State Teach-  
ers' Retirement System in February 1966 to review and  
ascertain the status of the previous recommendations. In  
his report the Auditor General recommended that a na-  
tional firm of certified public accountants be retained to  
make a management survey of the system.

In October 1966, following a further request from the  
Joint Retirement Committee, we drafted "A Request for  
a Proposal to Conduct a Management Survey of the State  
Teachers' Retirement System." This proposal, with minor  
alterations, was submitted to various recognized consult-  
ing firms by the Joint Retirement Committee, and the  
Auditor General participated in a number of meetings  
with representatives of consulting firms.

In December 1966, a contract was approved with the  
firm of Peat, Marwick, Mitchell and Company for a man-  
agement survey of the system, and this work is now in  
process.

We do not believe the State Teachers' Retirement Sys-  
tem should exist on the general faith and credit of the  
State of California. The state should pay for the costs  
of service at the time the service is performed. We restate  
two of the recommendations contained in the report on  
this subject, dated January 25, 1960.

- (1) We recommend that a determination be made of  
annual contributions required over various periods  
of time to place the State Teachers' Retirement  
System on the same sound actuarial reserve basis  
as the State Employees' Retirement System.
- (2) We recommend that legislation be proposed to place  
the State Teachers' Retirement System on a sound  
actuarial basis, to appropriate amounts necessary  
to fully fund service credits accrued to date, and to  
provide for the appropriation of amounts necessary  
to fund on a current basis the service credits accru-  
ing from year to year.

In the report on the system dated January 25, 1960, we  
recommended that future legislation be directed toward

discontinuing the local teachers' retirement systems still in effect. In our opinion, the continuance of separate local systems hampers the State Teachers' Retirement System, and prevents it from becoming a more efficient operation.

We stated, also, that the cost of administration per member of the state system was greater for those members who were also members of a local system. We are still of this opinion, and therefore repeat this recommendation.

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**CHAPTER SIX**

**LONG BEACH TIDELAND TRUST FUNDS**

As trustee, the City of Long Beach holds certain tide and submerged lands which were granted by the State of California pursuant to Chapter 676, Statutes of 1911; Chapter 102, Statutes of 1925; and Chapter 158, Statutes of 1935. Under the terms of the grants, the city has jurisdiction over the lands for the purpose of navigation, harbors, commerce, fisheries, and recreation.

Oil and gas development on the granted tidelands began in 1959, and as of June 30, 1966, had resulted in net revenues of approximately \$470 million. This amount was divided between the city and the state, and does not include a \$10 million advance payment received during 1964-65.

Chapter 29, Statutes of 1956, provides for the distribution of 50 percent of the oil revenues and all dry gas revenues to the State of California. The remainder of the oil revenue and all other income from trust facilities are retained by the city for development and operation of the tidelands consistent with the purposes set forth in the grants and in Chapter 29.

Development of the new East Wilmington oilfield, which is anticipated eventually to produce more than \$3 billion in gross revenue, resulted in further legislation being enacted. Chapter 138, Statutes of 1964, supersedes older provisions and regulates the new field as follows:

- (1) Provides for development of the East Wilmington field.
- (2) Provides for distribution of oil revenue between the City of Long Beach and the state, with the state receiving 85 percent of net revenues and the city receiving 15 percent of net revenues.
- (3) Sets forth more specifically the purposes for which the city may expend its share of oil revenue, and gives the State Lands Commission more control over the city's trust activities.
- (4) Provides for establishing the upland boundary of the tidelands, exclusive of the Alamitos Bay region.
- (5) Provides that the state shall pay 50 percent of subsidence costs, instead of the former 25 percent.

- (6) Provides for an annual post audit of the tidelands funds by the Office of the Auditor General, and an annual report on the subject to the State Legislature.

In February 1965, the City of Long Beach received bids for development of the Long Beach unit of the East Wilmington field. The successful field contractor, with an 80 percent interest in production from the unit, is a syndicate composed of the Texaco Oil Company, Humble Oil Company, Union Oil Company, Socony Mobil Oil Company, and the Shell Oil Company.

Collectively, the syndicate is known as THUMS Long Beach Company, and the field contractor and other interests' combined bids will yield 96.2528 percent of the net profit to the tideland trust. Under terms of the contractor's agreement, a \$10 million advance payment was made to the City of Long Beach of which the state received payment of \$5 million. Production within the new unit did not begin until after June 30, 1965.

The Auditor General's examinations of the tidelands funds of the City of Long Beach have been welcomed by city officials, and the cooperation received has been excellent to date. Recommendations have been accepted and implemented promptly wherever possible, and the Auditor General's staff have been able to adjust most differences while the audit work was in process.

The examinations are made in accordance with generally accepted auditing standards, and include such tests of the accounting records and procedures as the Auditor General considers necessary. The report on the year ending June 30, 1966, is now in preparation and will be transmitted to the Legislature shortly.

Statutes relating to the Long Beach tidelands provide for the state to receive 100 percent of the reasonable wholesale market value of all dry gas sold. The dry gas sold to the city municipal gas system from July 1959 to January 1963 did not meet this requirement, and the state received less than wholesale market value.

The Auditor General informed us in February 1963 and again in May 1965 that this matter had not been resolved by the State Lands Commission. Under certain circumstances, it appeared as much as \$500,000 could be due to

the state for the gas mentioned above.

The State Lands Commission as follows:

July 29, 1965

"Negotiated for gas deliveries

July 25, 1965

"Discussed with the private gas companies subsequent to the audit staff's report on organizational changes and urgent matters which will be resolved.

On January 1966, the Auditor General's report

"... the state does not have a reserved interest in the Gas Conservation Fund relating to the amounts received by the State Lands Commission should be regarding the fact that the state has not been as anxious to appropriate funds as the City has, and that this year, 1965, we have a commission of

The chairman responded with the Chairman of the Commission in 1966, bringing the matter requesting a study.

After a further study was constituted, the chairman submitted copies of his



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The State Lands Commission replied to our enquiries  
as follows:

July 29, 1963:

"Negotiations for settlement of charges on past  
deliveries are currently in process."

July 25, 1965:

"Discussions with the City of Long Beach relative  
to the price of dry gas delivered into the city lines  
subsequent to August 1, 1959 were suspended to per-  
mit staff time, both city and state, to be concentrated  
on organization of the Long Beach Unit and other  
urgent matters. It is anticipated that negotiations  
will be resumed in the near future."

On January 10, 1966 the City of Long Beach informed  
the Auditor General:

"... the City is aware of this liability and, while  
we do not concur with the amount mentioned, we have  
reserved funds to meet our obligations. The City's  
Gas Consulting Engineer has prepared a report re-  
lating to this adjustment and computed the various  
amounts pertaining thereto. We have been advised  
by the State Lands Commission that a conference  
should be scheduled to complete the negotiations re-  
garding this matter. While, to date, such a meeting  
has not been called, please be assured the City is most  
anxious to resolve this issue at the convenience of the  
appropriate State agency. You are aware that the  
City has, on numerous occasions in the past, reiter-  
ated this position and, as recently as December 8,  
1965, we advised the staff of the State Lands Com-  
mission of our desire to settle this entire matter."

The chairman of the Joint Audit Committee corres-  
ponded with Lieutenant Governor Glenn M. Anderson,  
Chairman of the State Lands Commission, on January 19,  
1966, bringing this matter to his personal attention, and  
requesting a speedy settlement of the issue.

After a further lapse of time with no action being in-  
stituted, the chairman of the Joint Audit Committee had  
copies of his correspondence with Lieutenant Governor

Anderson printed in the *Assembly Daily Journal* for May 17, 1966. Additionally, copies of the correspondence were circulated to the Speaker of the Assembly, the chairman of the Assembly Committee on Public Utilities and Corporations, and the chairman of the State Senate Committee on Natural Resources.

On September 26, 1966, the State Lands Commission approved a settlement with the Municipal Gas Department of the City of Long Beach for tideland dry gas received by the city during the period July 1, 1959-January 31, 1963. The settlement resulted in the state receiving **an additional sum of \$161,713** in payment for the dry gas.

## THE

While in process of the California State Budget, 1966, the Legislature usually large number of 66 fiscal year.

As part of the centralized payroll system, the controller's office, the disbursing office, and the payroll exceptions.

The State Comptroller pay only those claims that exist, and which are budget allotments.

Budget Division exercises control over changes in budget and budget documents. Documents approved in the office of the California State Comptroller to the Department of Finance.

The State Comptroller until all documents have cleared both the Department of Finance and the Department of General Services in the cases noted.

Most of the requests originating and authorized positions are.

Relying upon the State Comptroller made payments proper documents. The controller did not report these exceptions were reported these exceptions at the time, accounts receivable amounts paid. Of these accounts receivable amounted to \$42

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CHAPTER SEVEN

THE CALIFORNIA STATE COLLEGES

While in process of examining payroll transactions of the California State Colleges for the year ending June 30, 1966, the Auditor General's staff observed an unusually large number of payroll exceptions for the 1965-66 fiscal year.

As part of the routine control procedures of the centralized payroll data processing system in the State Controller's office, these exceptions are reported daily to the disbursing officer. At the time of the inspection the payroll exceptions **amounted to approximately \$1 million.**

The State Controller's payroll system is designed to pay only those employees for whom established positions exist, and which have sufficient funds available in the budget allotment.

Budget Division of the Department of Finance exercises control over establishing positions, and over changes in budget allotments. Also, payroll documents and budget documents require Department of Finance approval. Documents prepared by state colleges must be approved in the first instance by the Board of Trustees of the California State Colleges before being submitted to the Department of Finance.

The State Controller cannot process a payroll claim until all documents relating to a position or allotment have cleared both the Board of Trustees and the Department of Finance. This procedure had not been followed in the cases noted by the Auditor General's staff.

Most of the reported exceptions were due to delays in originating and obtaining approval of changes in authorized positions and budget allotments.

Relying upon later certification, the State Controller made payments to individuals when approvals and proper documentation were pending. If the State Controller did not receive the required documents, exceptions were reported to the state colleges involved. If these exceptions were not cleared within a reasonable time, accounts receivable were established for the amounts paid. On April 30, 1966, the State Controller's accounts receivable for state college payroll exceptions **amounted to \$45,064.**

It was clear to your committee that a major breakdown had occurred in the policies, procedures, and controls over certain state college payrolls and budget allotments.

The breakdown resulted in the following problems:

1. Added cost to the state due to the processing of an unusually large number of payroll exceptions, salary advances, and related documents.
2. Delayed salary payments, or no salary payments to certain employees.
3. Increases in state college revolving cash funds to offset salary advances.
4. Payment of salary advances out of funds received for other purposes.
5. Incorrect reporting of employee earnings, income tax withholding, and social security.
6. Employees required to pay a higher income tax due to earnings being reported in the wrong calendar year.
7. Employees required to pay a higher social security rate due to earnings being reported in the wrong calendar year.
8. Due to increases in income tax and social security rates, payroll warrants when issued could be less than salary advances. This created collection problems and possible losses on employees who had left state service.

When the State Controller was unable to issue a payroll warrant, the state college involved was notified. In most cases, the college would issue a revolving fund check advancing the net pay to the employee.

During the 1965-66 fiscal year up to the time of the review, San Francisco State College had issued 1,700 salary advances. This procedure resulted in an augmentation of the college revolving fund, and revolving fund increases at certain selected colleges were as follows:

College	Revolving funds		
	7-1-65	3-31-66	Increase
San Francisco .....	\$125,000	\$300,000	\$175,000
San Diego .....	41,000	160,000	119,000
San Fernando Valley .....	80,000	280,000	200,000

In addition, Los Angeles State College paid \$69,802 in salary advances on April 8, 1966, causing an overdraft

of \$40,039 in 1 purposes was

Salary advance employees affected and other funds not paid or received. State Controller's report resulted in an audit and tax withheld. December 31, received until

Increases in five January employees, and less than the left state service experienced during the payroll was

Advances to at certain selected

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- (2) Conversion position
- (3) Establishing funds.

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of \$40,039 in this revolving fund. Cash received for other purposes was used to cover the overdraft.

Salary advances were made for the net amount due the employees after deducting withholding tax, retirement, and other fringe benefits. However, the deductions were not paid or reported to the proper authorities until the State Controller's warrant was issued. This practice resulted in an incorrect reporting of employee earnings and tax withheld when advances were paid prior to December 31, 1965, and the Controller's warrant was not received until after this date.

Increases in income tax and social security rates effective January 1, 1966, have resulted in higher costs to employees, and in colleges receiving payroll warrants for less than the amount paid in advances. If an employee left state service during this period the college usually experienced difficulty in collecting the difference between the payroll warrant and the advance.

Advances to employees as a result of payroll exceptions at certain selected colleges, were as follows:

College	12-31-65	4-30-66
San Fernando Valley -----	\$97,473	\$25,904
San Francisco -----	73,622	31,253
San Jose -----	30,490	8,725

Processing payroll exceptions, accounts receivable, salary advances, and the required documents to clear exceptions is costly to the state. Four or more levels of administration are involved, and numerous documents and communications.

The payroll exceptions noted have been broken down into three major problem areas. These were:

- (1) Work-study programs,
- (2) Conversion of permanent positions to temporary positions, and
- (3) Establishment of reimbursed positions for programs financed by federal and other nonstate funds.

It is difficult to pinpoint responsibility for the large number of payroll exceptions. Many factors at various levels of administration contribute to the problem, and a list of contributing factors follows:

**At the State College Level**

- (1) Inexperienced personnel staff
- (2) Lack of coordination between personnel staff, and accounting and budgeting staffs,
- (3) Delay in originating documents, and
- (4) Hiring personnel before positions were approved.

**At the Board of Trustees Level**

- (1) Inexperienced personnel staff,
- (2) Inadequate knowledge of control procedures, and
- (3) Staff too preoccupied with planning and budgeting future programs, thus allowing routine payroll documents to accumulate.

**At the Department of Finance, Budget Division, Level**

- (1) Delays in establishing policy on new programs, resulting in retroactive changes,
- (2) Delays in approving payroll documents, and
- (3) Controlling detail expenditure transactions, instead of controlling programs through workload standards and broad policy directives.

At California State Polytechnic College-Kellogg Voorhis, four employees were appointed to and paid from unapproved positions during the first half of the 1965-66 fiscal year. Later, when position approval was not received, the college separated the employees and the State Controller set up accounts receivable for the amounts paid in salaries.

To clear the accounts receivable, the college certified that the separated employees had worked as student assistants in the month of April 1966. The total number of hours certified was far in excess of the working hours possible during that month. The certifications for April were as follows:

**April 1966 student assistant attendance report**

Employee	Position	Hours reported	Amount
A	Key punch operator .....	1,157	\$2,624
B	Intermediate typist-clerk .....	594	1,251
C	Intermediate typist-clerk .....	1,224	2,934
D	Key punch operator .....	547	1,211

At the time of our inspection, San Francisco State College had payroll accounts receivable dating back to December 20, 1962. One former employee owed the state

\$6,640.92. The and up to the \$50 each had July 1964, w at the college

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## Report

Reported	Amount
1967	\$2,624
1964	1,251
1964	2,934
1967	1,211

San Francisco State Col-  
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\$6,640.92. The original balance of this debt was \$6,740.92, and up to the time of our review only two payments of \$50 each had been received. The receivable originated in July 1964, when the employee failed to return to work at the college after being paid for a sabbatical leave.

State Controller's warrants were not issued for students working under the federal antipoverty, work-study program at Sacramento State College in March 1966 until May 5, 1966. Seventy students requested and received salary advances totaling \$6,685. Sixty-three students received no payment until the Controller's warrants were issued.

Several of the 1965 summer session instructional faculty at Sacramento State College were paid salary advances from the college revolving fund on October 14, 1965. State Controller's payroll warrants were not issued until February 1966.

This situation resulted in employee earnings being incorrectly reported for tax purposes in the 1966 year, and the understating of 1965 earnings and tax withheld. At the same time, 1966 earnings and tax withheld were overstated.

We have recommended a thorough study of state college payroll problems and current payroll procedures. We believe new procedures should be devised to bring about effective control, taking into consideration any special payroll problems the colleges may have. Our report on this subject of May 17, 1966, was transmitted to the State College Board of Trustees with a request for prompt action.

We have received several replies from the board of trustees and the office of the chancellor since that time. College officials have demonstrated commendable concern over the problem of payroll documentation and processing. We have been assured that a number of corrective steps have already been taken, and that this situation will be resolved as expeditiously as possible.

## CALIFORNIA STATE COLLEGE AT DOMINGUEZ HILLS

Originally known as South Bay State College, later known as Palos Verdes State College, and now officially known as Dominguez Hills State College, this campus was established by statute in 1960.

Planning of curriculum and facilities began in the 1961-62 fiscal year with the acquisition of a college planning staff. A tentative plan to accommodate 16,000 full-time-equivalent students has been approved by the state college board of trustees, and enrollment began in the fall quarter of 1965.

The costs of operations at this college do not compare favorably with the statewide averages of the California state college system. However, the following should be kept in mind:

- (1) This is a new college, now in its second year of operation
- (2) Considerable delay was experienced in site acquisition, causing uncertainty as to the permanent location of the college
- (3) Land acquisition is only now in the final stages
- (4) The college does not have permanent buildings and is operating in temporary rented quarters
- (5) Location and quality of the rented facilities was uncertain until late in the spring of 1966

These factors may have contributed to actual enrollment being less than estimated with a resulting high cost of operation, but unless enrollment substantially increases in the fall of 1967 we believe the board of trustees should review faculty size and program scope with a view to achieving savings for the state.

The support budget for the 1966-67 fiscal year is approximately \$1.4 million. Expenditures for the first seven months of the fiscal year indicate that total expenditures for the year will not be substantially less than the budgeted figure.

#### **Estimated Enrollment Compared With Actual**

	1965-66	1966-67	1967-68
Estimated .....	90	310	490
Actual .....	38	120	--
Estimated over actual .....	52	190	--

The actual enrollment of 120 students shown for the 1966-67 year is taken from the 1967-68 budget. Actual full-time enrollment for the fall and winter quarter was 110 students. The college anticipates an increase of about 50 students for the spring quarter, therefore we have

used the figure from our report.

#### **Net Expenditure**

Dominguez Hills State college average

Dominguez Hills State college

The above expenditures per student. Capital expenditures per student average, the Dominguez Hills college average for the 1966-67 year is the state average.

#### **Student-Faculty**

Dominguez Hills State college average

This ratio of students to faculty. The 1966-67 year average for the Dominguez Hills college was 11 students per faculty member. The 1966-67 year average for the state is 12 students per faculty member. This is expected to be the same for the 1967-68 year.

(1) Average number of students per faculty member

State college average  
Dominguez Hills college

(2) Average number of students per faculty member  
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used the figure of 120 students for the 1966-67 year in  
our report.

Net Expenditures per Full-Time-Equivalent Student

	Actual 1965-66	Estimated 1966-67	Proposed 1967-68
Dominguez Hills (excluding rent)	\$10,233	\$9,280	\$2,593
State college average	1,179	1,278	1,207
Dominguez Hills over average	\$9,054	\$8,002	\$1,386

The above table shows the average cost of support  
expenditures to provide one year's education for one  
student. Capital outlay is not included in the state col-  
lege average, and we have not included rental charges in  
the Dominguez Hills expenditures. The table shows that  
the actual cost of educating one student at the Dominguez  
Hills college was approximately **nine times the state  
average** for the 1965-66 year and the estimated cost for  
the 1966-67 year will be approximately **eight times the  
state average**.

Student-Faculty Ratio

	Actual 1965-66	Estimated 1966-67	Proposed 1967-68
Dominguez Hills	7.60	4.85	11.95
State college average	15.81	16.29	16.53

This ratio measures faculty productivity and other  
factors. The Dominguez Hills ratio is based on 24.75 full-  
time-equivalent teachers, the current faculty staff. The  
college was staffed to handle 310 students, but only 120  
students enrolled. No substantial change in staffing or  
program has been made to compensate for the reduced  
enrollment. Based on the ratio shown above the faculty  
size for the 1966-67 year is **three times the state average**  
for the number of students enrolled.

This is explained further by the following statistics:

- (1) Average teacher load, representing the average  
number of units of classroom instruction:

State college average	12 units
Dominguez Hills	10 units

- (2) Average number of students per class:

State college average	20.36
Dominguez Hills (fall quarter of 1966)	7.23

Following, by class size is an analysis of classes given by Dominguez Hills College during the 1966 fall quarter:

<i>Number of students per class</i>	<i>Number of classes</i>
1 -----	10
2 -----	4
3 -----	5
4 -----	3
5 -----	2
6 -----	2
7-10 -----	16
10-20 -----	13
25 -----	1
Total classes -----	56

From this analysis it can be seen that there are 10 classes with only 1 student per class; 19 classes with 3 or less students per class; 26 classes with 6 or less students per class; and only one class with more than the state college average of 20.36 students per class.

Enrollment by subject field was as follows:

	<b>Total number of students</b>	<b>Number of classes</b>	<b>Average number of students per class</b>
Spanish—see note (a) -----	3	2	1.5
French—see note (b) -----	4	1	4.0
Physics -----	4	1	4.0
Geography -----	8	1	8.0
Philosophy—see note (c) -----	9	2	4.5
Sociology -----	9	3	3.0
Music—see note (d) -----	12	5	2.4
Health and physical education ---	14	1	14.0
Biology -----	16	3	5.3
Political Science -----	19	3	6.3
Economics -----	21	2	10.5
Psychology—see note (e) -----	31	4	7.7
Chemistry—see note (f) -----	32	5	6.4
Art -----	37	2	18.5
Mathematics -----	48	6	8.0
History -----	63	6	10.5
English -----	75	9	8.3
Total -----	405	56	7.2

(a) Spanish—the Spanish instructor was employed full time, and taught only 3 students.

(b) French—the French instructor was employed two-thirds of the time, and taught one class with 4 students.

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- (c) Philosophy—the philosophy department had one instructor employed two-thirds of the time. This instructor taught one class with one student, and a second class with 8 students.
- (d) Music—the music department had two full-time instructors. Four classes were held with a total of 5 students, and a fifth class contained 7 students.
- (e) Psychology—this department had two instructors. One instructor taught one class with 10 students.
- (f) Chemistry—one full-time instructor taught two classes with a total of 3 students.

Land Acquisition

An appropriation of \$5 million was made for land acquisition by the Statutes of 1962. An augmentation of \$6 million was made in the Statutes of 1966, thus setting aside a total of \$11 million for the acquisition of land.

The site originally chosen for the college was located on the Palos Verdes Peninsula, but attempts to purchase this site were abandoned in July 1965. The Dominguez Hills site then was selected from 42 other possible locations reviewed, and this site consists of two parcels of land containing 356.28 acres.

Parcel No. 1 containing 82.87 acres was purchased in January 1967 for \$2,595,000. Mineral rights to this land were retained by the seller. The purchase price included the cost of the land at \$28,478 an acre, plus \$235,000 in damages for the capitalization of oil left underground by the closing of 12 wells on the property.

The state is now negotiating with the Shell Oil Company for the elimination of the 12 wells. This would include removal of the pumping equipment, plugging the wells, and removing service lines. This work would cost an additional \$595,000.

Parcel No. 2 containing 273.41 acres is currently in escrow. The cost of this land is \$7,555,000 or \$27,632 per acre. As in parcel No. 1, only the surface rights are being purchased. Currently, there are three oil wells operating on this property, and these will be allowed to remain in operation. No damages are included in the purchase price, but additional costs of \$60,000 to \$80,000 will be incurred by having the Union Oil Company relocate pipe and power lines.

Total purchase price of the two parcels of land will be close to the \$11 million appropriated.

**Temporary Rented Quarters**

The college is now operating in rented facilities consisting of 60,980 net square feet. The term of the lease is four years from September 1, 1966–August 31, 1970. The state may terminate the lease on August 31, 1967, or on any date thereafter by giving 90 days' notice.

Cost of lease is 39.42 cents per square foot, or \$288,484, for the first year; 38.10 cents per square foot, \$278,784, for the second year, and 31.33 cents per square foot, or \$229,240, per year thereafter. The lessor provides janitorial services.

Space was rented for 600 to 700 students, the estimated need for 1967–68. The amount of rental was not included in the cost per student calculation given earlier in this chapter. The rental cost per full-time-equivalent student would be **\$2,404 for the first year alone.**

Current plans call for the college to vacate the rented facilities in the fall of 1968.

**Construction**

An appropriation of \$1,338,600 was made in 1964 for the construction of initial buildings to accommodate 827 students. Land acquisition was not accomplished, and the buildings have not been constructed.

Plans now call for completion of this program by the fall of 1968. Due to the lag between appropriation and construction, an augmentation of approximately \$250,000 may be needed.

In 1966, appropriations were made for \$5,145,500 for construction of a library-classroom-administration building, and \$2,802,000 for construction of a science building. The library building will accommodate 626 students, and the science building 541 students. These buildings are currently scheduled for completion in the fall of 1969.

A social science building budgeted in the 1967–68 year is scheduled for completion in 1970. This building will accommodate 1,212 students at a cost of \$2,126,000.

The currently proposed construction program will accommodate 827 students in 1968–69; 1,994 students in 1969–70; and 3,206 students in 1970–71.

The operation of the California State Library follows:

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The California State Library's internal audit service is a part of the Department of Finance. Much to be done.

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The operating costs and available appropriations for the California State College at Dominguez Hills are as follows:

**Money Spent on Operation of College  
from 1961 to January 31, 1967**

Project planning -----	\$165,777
Operations -----	2,012,692
Library -----	297,478
Land and buildings -----	2,992,278
Total -----	\$5,468,225

**Appropriations Available but Unspent to Date**

Project planning -----	\$88,974
Operations -----	754,571
Library -----	2,522
Lands and buildings -----	30,839,022
Total -----	\$31,685,089

**CONCLUSION**

The California state college system does not have an internal audit unit operating within the system. This service is provided by Audits Division of the Department of Finance, but we believe the present procedure leaves much to be desired.

Many of the payroll exception problems and other problems of similar nature probably could have been avoided if the system had its own staff of qualified internal auditors.

Therefore, we strongly recommend that an internal audit unit be established within the office of the chancellor, and that this unit operate under the direction and authority of the chancellor of the state college system.

## CHAPTER EIGHT

### HEALTH AND WELFARE AGENCY, OFFICE OF HEALTH CARE SERVICES—HEALTH CARE DEPOSIT FUND

#### (THE MEDI-CAL PROGRAM)

Chapter 4, Statutes of 1965 (Second Extraordinary Session), created a new medical assistance program, and as principal operating fund for the program also created the Health Care Deposit Fund. The new medical assistance program has become known as the Medi-Cal program, and has been in effect since March 1, 1966.

Purpose of the Medi-Cal program is to provide basic and extended health services to recipients of public assistance and the medically needy. The program is administered by the Health and Welfare Agency, and financial accounting for the program and the Health Care Deposit Fund is done by employees of the Department of Social Welfare.

Two older programs, Public Assistance Medical Care (PAMC) and Medical Aid to the Aged (MAA) have been incorporated into the Medi-Cal program, and the new program is wide enough in scope to operate within the provisions of Title XIX of the Social Security Act. As a result, the Medi-Cal program is on a 50-50 cost sharing basis with the federal government.

The Auditor General's staff has examined the statement of financial condition of the Health Care Deposit Fund for the year ending June 30, 1966, and the related statement of operations for the four months the program was in effect. The examination was made in accordance with generally accepted auditing standards, and included such tests of the records and procedures as the Auditor General considered necessary in the circumstances.

However, the Office of Health Care Services' estimate of the counties' share of program costs was not audited, nor county and fiscal intermediary records supporting expenditures of state and federal money advanced for aid and administrative costs.

We estimate that the balance of the Health Care Deposit Fund as of June 30, 1966, is overstated by approxi-

**mately \$27.2 million.** This is due to the following omissions and adjustments:

- (1) No mention has been made in the financial statements of the fund's liability for unpaid medical aid bills prior to June 30, 1966. This liability is estimated to be approximately \$47.5 million.
- (2) No provision has been made for the option provided to counties under Section 14150.1 of the Welfare and Institutions Code. This involves a net additional cost to the fund of approximately \$7.1 million.
- (3) We estimate that amounts due from the federal government are understated by \$31.8 million, and an additional estimated \$3.7 million is due from the General Fund of the state.
- (4) We estimate that the amount received from the counties for their participation in the program is overstated by \$8.1 million.

Due to the materiality of the errors described above, the Auditor General does not believe the financial statements present fairly the financial position of the Health Care Deposit Fund for the year ending June 30, 1966, or the results of operations for the four-month period involved.

The counties' share of the costs involved in the first four months of the Medi-Cal program have not yet been determined. In order to arrive at this figure, it is necessary for the office of Health Care Services to audit county medical assistance costs for the 1964-65 fiscal year and reach agreements with the counties on the correct amounts.

The Medical Assistance program provides for county participation in costs of the program. Basically, the county share of the cost is not to exceed those incurred during the 1964-65 fiscal year for health care, and county administration of medical assistance to the aged and public assistance recipients. The county share is to increase each year in an amount proportionate to the increase in population.

Section 14150.1 of the Welfare and Institutions Code gives counties the option of extending the scope of the program by including the unreimbursed cost of health

care for all other hospitals.

Election of base period cost have the effect of program. Costs tend to increase. We estimate involve an additional

The actual medical aid bill by three fiscal years the state. The

- (1) Blue Cross of California.
- (2) Blue Cross of California.
- (3) Blue Shield of California.

During the first four months of the state program, approximately \$1.3 million for partial

The Office of Health Care Services is reviewing each intermediate certification of medical assistance transactions and planned for the safeguard state

One of the purposes of the Medi-Cal program is to determine the eligibility of

County welfare workers are determining the Department of Social Services eligible recipients, intermediaries provided, the locating him of Social

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Election of the option provision would increase the base period costs for the 1964-65 year, but would also have the effect of increasing the state cost of the program. Costs to the federal government would not increase. We estimate that election of this option will involve an additional state contribution of \$7.1 million.

The actual verification, processing, and payment of medical aid bills under the Medi-Cal program is handled by three fiscal intermediaries who have contracted with the state. These are:

- (1) Blue Cross (North): Serving hospitals, nursing homes, and other institutions in northern California.
- (2) Blue Cross (South): Serving hospitals, nursing homes, and other institutions in southern California.
- (3) Blue Shield (California Physicians Service): Serving doctors, pharmacists, and other professional vendors statewide.

During the four-month period prior to June 30, 1966, the state provided these fiscal intermediaries with \$72.2 million for payment of medical aid bills, and an additional \$1.3 million to cover their administrative costs.

The Office of Health Care Services maintains a staff in each intermediary office to make necessary preaudits and certifications of payments. No post audits of the fiscal transactions and records have been made, but these are planned for the future and are necessary to adequately safeguard state funds.

One of the major difficulties experienced in the Medi-Cal program to date has been the process of determining eligibility of persons applying for benefits.

County welfare departments have the responsibility of determining the eligibility of recipients. Through the Department of Social Welfare, counties furnish data on eligible recipients to the fiscal intermediaries. After intermediaries have determined the propriety of services provided, they must verify the recipient's eligibility by locating him in a file furnished to them by the Department of Social Welfare.



Problems have been encountered with this procedure. For example, in November 1966 the Health and Welfare Agency authorized partial payments of up to 70 percent of certain claims unpaid due to eligibility problems. Under this authorization, more than \$3.5 million in partial payments were made.

We are informed that in the future the Department of Social Welfare may assume the responsibility of verifying eligibility of recipients.

We have recommended that the Office of Health Care Services continually review eligibility certification operations to ensure that all the data is being appraised and that bills for services are being paid or rejected on a current basis.

The Office of Health Care Services is not able to state accurately the financial position of the Health Care Deposit Fund, or determine that the fund is complying with the limitations of the law regarding expenditures. A major difficulty is determining at any time the amounts of unpaid medical bills.

An accurate accrual for preparation of financial statements at the end of the fiscal year, and accurate estimates for forecasting expenditures by fiscal years are needed for budgetary and administrative purposes.

Another major problem to date is lack of experience with the program, and failure to obtain and analyze information. The fiscal intermediaries, when paying medical bills, record both the date of payment and the date services were actually rendered. This information is recorded on electronic tape, and if analyzed and utilized would be of considerable help for accounting and estimating purposes.

The Office of Health Care Services is contemplating such analysis, but so far has taken no positive action to implement the procedure.

Section 14150 of the Welfare and Institutions Code, specifies that expenditures of the fund, exclusive of the maximum available federal funds, shall not exceed \$18.25 per month for each eligible recipient.

The most recent estimates indicate that expenditures for the first four-month period of the program approximate this figure. However, an exact amount cannot be determined until the county share and the actual dollar

amount of utilization) are estimated to remove the Medi-Cal program session.

Vendors have to submit bills that tabulate each month, by month, the dollar amount.

Each quarter, the amount of federal expenditures during the quarter, the Department of Medi-Cal quarterly that the Health Care Account received did not include recorded medical

It is now estimated that the \$31.8 million

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amount of unrecorded medical bills (estimated at \$39 million) are established. The Legislature is now attempting to remove the ceiling of \$18.25 per recipient until the Medi-Cal program can be more fully studied by the 1967 session.

Vendors have six months after services are provided to submit bills for payment. For this reason, we believe that tabulations of the amounts of medical bills paid each month, by month of service, would facilitate estimating the dollar amount of outstanding bills at any given time.

Each quarter, an accountability statement of the amount of federal funds on hand, the amount received during the quarter, and the amount of reimbursable expenditures made during the period is filed with the U.S. Department of Health, Education and Welfare. The Medi-Cal quarterly statement of June 30, 1966, showed that the Health Care Deposit Fund had a federal account receivable of \$15.1 million. However, this amount did not include an estimate of the federal share of unrecorded medical bills.

It is now estimated by the Office of Health Care Services that the federal account receivable of this date was \$31.8 million.

The Department of Social Welfare prepares a similar federal quarterly statement for the aid programs it administers. The last Medical Aid to the Aged statement, prepared for the quarter ending March 31, 1966, showed \$2.9 million due to the federal government from this discontinued program, and cash on hand of \$4.6 million. The \$2.9 million due to the federal government was incorporated into the June 30, 1966 quarterly statement of the Medi-Cal program.

The June 30, 1966, quarterly statement of the Medi-Cal program has not been reconciled to any general ledger amounts. In order to make such reconciliation, accounts in both the Health Care Deposit Fund and the Social Welfare Federal Fund will have to be taken under consideration.

We believe the Office of Health Care Services should work with the Department of Social Welfare in making this reconciliation, and in determining disposition of any assets remaining for the discontinued Medical Aid to the

Aged program and Public Assistance Medical Care program.

Section 51507 and Section 51511 of Title 22, California Administrative Code, specify that from 5 percent to 10 percent of amounts payable to hospitals, nursing homes, and convalescent homes shall be withheld by the fiscal intermediaries until an audit of the cost statements is made.

An amount of \$3.1 million had been withheld from these vendors as of June 30, 1966. Bills supporting the amounts withheld have met the criteria for payment, and amounts paid to the vendors are included in the financial statements. However, the \$3.1 million withheld was not recorded as an expenditure or a liability.

Of the amount withheld, \$2.1 million was paid to nursing and convalescent homes in December 1966, but the \$1 million withheld from hospitals has not been paid.

The report discussed above covers the operations of the first four months of a very complex program. The financial statements prepared as of June 30, 1966, are obviously incorrect, and accurate information is not yet available.

We have proposed a total of nine recommendations to date, and we believe that the Office of Health Care Services must direct considerable attention and effort to preparation of financial statements for the Health Care Deposit Fund. The statements must show, as accurately as possible, the financial condition and results of operations of the fund in accordance with generally accepted accounting principles and applicable state laws.

## TRANSPORTATION

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## CHAPTER NINE

### TRANSPORTATION AGENCY—EVALUATION OF THE INTERNAL AUDIT PILOT STUDY

For several years we have expressed dissatisfaction with internal audit procedures in the executive branch of California state government. We have issued reports and a number of recommendations on this subject, and we continue to believe that much greater efficiency and economy is possible if internal audit procedures are revised and improved.

In the past, we have strongly recommended that each major agency of state government be given an adequate internal audit staff, and that this staff be placed under the operational control of the agency administrator. The pilot study discussed in this chapter was instituted as a result of our previous recommendations.

On May 20, 1965, a statement of intent was adopted by a subcommittee of the Assembly Committee on Ways and Means, chaired by Assemblyman John Williamson. The statement of intent, later approved by the full committee, incorporated a proposal to make an internal audit pilot study within an agency of the state government.

This statement of intent formed the basis for a memorandum of agreement setting forth the terms and general plans of the pilot study. The memorandum of agreement was signed by the Auditor General; the Chief of Audits Division, Department of Finance; and, following agreement on the agency to be selected, the Administrator of the Transportation Agency.

The general plan of the pilot study called for the assignment of the same number and grades of auditors normally used by Audits Division, Department of Finance, in its work within department and divisions of the Transportation Agency. This group of auditors (approximately 10 in number during the period involved) were augmented by the internal auditors from the Department of Public Works, the Department of Motor Vehicles, and the California Highway Patrol. The entire group was to be attached organizationally to the administrator for the duration of the study.

One purpose of the pilot study, as embodied in the general plan, was to determine whether management auditing could be made more effective. Another purpose was to establish whether a single audit group directly responsible to, and under the direction of, the Agency Administrator would be an improvement over internal auditing carried out by several, separate staffs working under separate control and direction.

The pilot study commenced in early January 1966 and terminated on December 31, 1966. In our opinion, the results of the study have been less than satisfactory, and certainly less than we had anticipated.

We believe that in order to provide a fair basis for comparison, audit operations during the study period should have been conducted as though a permanent rather than a temporary reorganization had taken place. The following list summarizes major limitations in this regard:

- (1) Actual transfer of personnel performing the pilot study was not made. Personnel were only on loan to the Transportation Agency, and were returned to original units at the end of the study.
- (2) Personnel on loan from other units naturally regarded this assignment as temporary, and retained all original allegiances.
- (3) The creation of a temporary staff did not encourage management to make any wider use of the audit activity.
- (4) Due to the short duration of the study, required development and revision of audit programs were not attempted.

It is difficult to determine what would have been accomplished during the same period of time, if the pilot study had not been in effect. As a result, it is difficult to present a clear conclusion on the value of the study. No generally accepted basis exists for evaluating the effectiveness or value of internal audit activity other than the use made of the activity.

The only tangible products resulting from audit effort are the published audit reports containing findings and recommendations for improvement. In addition, evaluation is hampered because the use management makes of

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The stated objective of internal auditing, as expressed by the Institute of Internal Auditors, is "service to management." Therefore, the feasibility of implementing the pilot study on a permanent basis is dependent upon the understanding and use made of the audit activity by management.

We believe that internal audit activity should be responsible to the highest level of management having specific authority over the operations subject to audit. Under the California Agency plan, administrators have this authority. Under the departmental plan, directors have this authority.

However, we expect management to have both the desire and ability to utilize broad scope internal auditing in the manner we describe in our published "Report on a Review of Internal Auditing Within the Executive Branch of California State Government."

A considerable part of any internal audit activity is the necessary repetitious examination of documents to establish the integrity of records; the determination that policies and procedures are being followed; and the verification that assets are intact.

For this type of work audit personnel need little management direction, and only if significant exceptions are reported need management be concerned. In addition, if audit personnel are limited to providing only these services it follows that organizational location of the audit staff is of little importance.

Determining that transactions are correctly reflected in accounting records, established policies and procedures are followed, and assets are intact can be the work of any audit group. Departmental internal auditors, employees of Audits Division, Department of Finance; or any group of external auditors can make such determinations with like efficiency. The placement of the audit group in the organizational structure has no significance.

During the year of the pilot study, internal audits within the Transportation Agency continued to be lim-

ited to the type of auditing described above. However, the following improvements were noted:

- (1) Audit communication showed improvement over prior years.
- (2) Duplication of construction contract auditing within the Department of Public Works was eliminated.
- (3) Audit coverage was increased.
- (4) Greater emphasis was placed on the examination of current transactions.

It may be that the improvements noted would have been implemented without the pilot study. This is difficult to determine. However, the following improvements we did anticipate **were not** accomplished:

- (1) Increased management direction and utilization of audit activity. Each unit comprising the pilot study continued to direct its own affairs without any recognizable increase in management participation.
- (2) Development of written audit programs. Lack of written audit programs continued for a substantial part of the study period.
- (3) Emphasis on statewide subject matter audit activities. Within the Division of Highways, the subject matter of audits continued to be based on the highway district geographical location instead of statewide activity.
- (4) A consistent method of communicating audit findings. Differing methods of communicating audit findings continued in effect.
- (5) Increased audit coverage over problem areas. Activities requiring more extensive auditing, i.e., federal aid recovery, did not receive any additional coverage.

We do not believe the failure to implement the improvements discussed above demonstrate a failing in the pilot study. Instead, they are the natural consequence of limiting the study to a "paper" transfer of employees on a temporary basis.

In a 1962 report regarding receipt of federal reimbursement for highway projects, we recommended that exami-

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nation of federal aid should be part of the regular internal audit program. No action was taken at this time, and we later repeated the recommendation in another report on the subject of internal auditing within the Division of Highways.

In our discussions with Transportation Agency and Department of Public Works administrative personnel to establish the program for the audit pilot study, there was general agreement this activity should be included. Further, during the year of the pilot study:

- (a) The problem of obtaining prompt and maximum federal reimbursements for highway projects was discussed before a joint meeting of the Senate and Assembly Transportation Committees, and again at a later meeting of the Assembly Transportation and Commerce Committee.
- (b) The amount of state funds used to advance the federal share of highway construction costs continued to increase. As of June 30, 1966, the amount was in excess of \$100 million. (See Chapter Three of this *Biennial Report*.)
- (c) We reported on the continued failure to recover all design costs from the federal government. Division of Highways personnel took no action to resubmit one \$300,000 claim after it was disallowed, although officials of the U.S. Bureau of Public Roads agreed with us that all, or a substantial part, of this amount could be recovered. (See Chapter Three of this *Biennial Report*.)

During the pilot study year, the only internal audit effort made on the subject of federal aid recovery was a brief procedural study which produced no findings worth communicating. The lack of any significant effort in this regard demonstrates the absence of real management control and direction over the internal audit activity.

As we have stated, the work of the audit staff of the Department of Public Works, the Department of Motor Vehicles, and the California Highway Patrol continued during the pilot study without noticeable modification. In addition, for the most part the program followed by the audit staff of the Department of Finance was developed prior to, and without regard to, the pilot study.



We found no evidence of increased management interest. The lack of such interest indicates that management believes the auditors are either better qualified to direct their own activities, or that the audit activity is unimportant.

We continue to believe the most useful internal auditing for management is broad in scope, and not limited to repetitious verification of records. Broad scope internal auditing can be of service in determining employee work standards; determining the need for a given activity, document, or report; determining alternate methods of performing an activity, or establishing employee production rates.

In addition, internal auditing can determine the adequacy of equipment, space, and facilities. By the use of broad scope internal auditing, management concerned with the efficient and economical administration of agencies, departments, or units are given an independent method of evaluating problems.

Early in the pilot study period, we supplied administrative personnel of the Department of Public Works and Division of Highways with a number of questions relating to economy and efficiency. We believed the internal audit staff could develop answers to these questions, and we assumed that management would share our interest in this matter.

Subsequent discussions with pilot study audit personnel revealed that no requests had been received from administration for any information regarding current operations or the questions we had posed.

The primary purpose of broad scope internal auditing is to provide management with an independent means of obtaining information, apart from the line organization responsible for carrying out official directives.

However, during the study period there was no requirement for any audit activity other than the usual audit verifications the staff themselves chose to perform. As a result, **there was no real pilot study.**

The pilot study failed to establish the value of providing top-level administrators with broad scope internal auditing coverage, but we continue to believe this plan affords the best basis for developing and maintaining efficient and economical practices.

The recently expressed desire to reorganize management. It is possible to modify or revise recommendations for future change in the placement of the

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The recently elected state administration has expressed a desire to reorganize the executive branch of government. It is possible the present agency structure will be modified or revised. Therefore, we cannot make any recommendations for future action at this time. Any significant change in the agency structure will affect the proper placement of the internal audit staff.

We will submit our recommendations on the utilization of internal audit personnel at such time as the new organizational plans are clarified and established.

## **CHAPTER TEN**

### **FINANCING OF SPECIAL EDUCATION PROGRAMS IN THE PUBLIC SCHOOLS**

In accordance with the provisions of House Resolution 489 of the 1966 Legislature, the Auditor General has studied the financing of special education programs in the public schools. The study included reviews of records and procedures at the State Department of Education, at eight selected school districts, and one county superintendent's office.

House Resolution 489 requested that studies be made to determine the reliability of cost data, the relative shares of costs borne by the state and local school districts, and the use and disposition of funds received for special education purposes. Our general conclusions relative to each of these follow:

1. Excess cost reports of the eight selected school districts and the one county superintendent of schools' office that we visited were found, with but two exceptions, to be correctly prepared.
2. In some instances, the state's reimbursement is substantially below the excess costs of special education. As education costs increase, the districts are bearing a greater proportion of the fiscal burden.
3. Funds received by school districts for special education are not being used in all instances for the particular purpose for which they were levied or apportioned.

A summary of specific findings and our recommendations follow:

#### **SUMMARY OF FINDINGS AND RECOMMENDATIONS**

1. The review of special education cost reports in support of reimbursement claims was too limited as to the number of districts and counties visited to determine the proportion of costs borne by each district and the state on a statewide basis.

**Recommendation**

We recommend that the Department of Education determine the relationship of costs borne by each district and the state, by programs, on a statewide basis and that the department recommend adjustments in statutory maximum allowances for special education programs where they appear to be justified.

2. State apportionments for special education programs are based on a district's prior year excess cost of conducting special education programs. In most cases, districts' current year excess costs are more than the amount currently received from the state. Also, the state does not share in the cost of new programs until the second year, which burdens the district with the full first year cost of a new program.

**Recommendation**

We recommend that special education apportionments be based upon the current year costs.

3. The excess cost of educating handicapped pupils in a district with low enrollment of such pupils exceeds the state's maximum allowances. If no alternate special education program can be arranged, a special allowance may be required to adequately support a necessary small class in a district.

**Recommendation**

We recommend that the Legislature consider the feasibility of granting a special allowance to school districts for necessary small classes for special education programs where an alternate facility cannot be provided.

4. School district accounting records and procedures are not designed to readily produce cost reports of special education programs, such as the cost of educating the blind, deaf, and multiple-handicapped children and others. Program cost information is needed by district and state officials, including the Legislature, when reviewing the financing of each program.

**Recommendation**

We recommend that the Department of Education and public school districts be required to submit annual reports to the Legislature on the status of special education programs.

5. The Legislature should consider the creation of a special education fund to provide for the cost of special education programs. The fund should be established by the Legislature and the Department of Education should be required to submit annual reports to the Legislature on the status of the fund.

**Recommendation**

We recommend that the Department of Education be required to submit annual reports to the Legislature on the status of special education programs.

6. The Department of Education should be required to submit annual reports to the Legislature on the status of special education programs.

**Recommendation**

We recommend that the Department of Education be required to submit annual reports to the Legislature on the status of special education programs.

7. The Department of Education should be required to submit annual reports to the Legislature on the status of special education programs.

### Recommendation

We recommend that school district accounting records and procedures be modified to provide for separate groups of accounts for recording the costs of special education programs.

5. The Education Code does not provide for the allocation of indirect salaries and wages, consisting primarily of general administrative salaries, to special education programs. This results in the understatement of costs of special education programs.

### Recommendation

We recommend that Section 17200.5 of the Education Code be amended to provide for the allocation of indirect salaries and wages to special education programs.

6. Education Code Section 17200.5 allows districts to charge a proration of certificated salaries and wages to special education programs in proportion to the time spent on special education programs "... upon substantiated evidence being presented." This results in the preparation and transmittal of voluminous detail information to the Department of Education.

### Recommendation

We recommend that the Legislature amend Section 17200.5 of the Education Code to read "... upon substantiated evidence or documentation being readily available for audit in the school district."

7. School districts are allowed to levy permissive tax overrides for certain, but not all, statutory mandated special education programs and certain programs which are not mandated. The amounts of permissive tax overrides have been **incorrectly determined** because revenues and costs of related programs have not been accurately reported. Because of this, **millions of dollars have been collected by school districts** for restricted purposes and used for other educational purposes.

**Recommendation**

We recommend that the policy regarding the use of permissive tax overrides and the methods of determining the amounts of such overrides be reviewed.

8. Information in school district budget documents, which are reported in the analyses section of General Fund taxes subject to tax rate limits, does not provide for the reporting of adjustments in restricted balances which may occur between years. The reconciliation of balances between years is necessary for control purposes.

**Recommendation**

We recommend that school district budget documents be revised to disclose adjustments in restricted balances that may occur between years.

9. Section 18351.1 of the Education Code requires that the Department of Education be notified and approve all line item budget changes within an activity or program in the county school service fund budgets. Since all changes are approved, these requirements result in unnecessary work with no improvement in control.

**Recommendation**

We recommend that control by the Department of Education over amounts budgeted be limited to a review of the overall activity or program of the county school service funds.

**COMMENTS**

The Auditor General's study of special education in California included a rather detailed review of existing legislation, special studies and reports made by other committees of the Assembly and Senate, including a recent report to the Assembly Subcommittee on School Efficiency and Economy concerned with school budgeting and accounting, and various reports on file at the Department of Education, and personal visits to selected school districts throughout the state, including one county superintendent of schools' office. Selection of school districts was made to include large, small, wealthy, and impoverished districts located within different geographical sections of the state.

Detailed comments relative to our general conclusions follow:

**Excess Cost Reports**

Considering the cost report forms are not designed on an activity basis, we were expended by districts were correctly stated.

In our review exceptions were statement of expenditure of expenditure was applying a indirect costs to formulas, unless conclusions as to used in statewide

Expenditures the district claimed salaries and tion programs. allocation of welfare accounting may 000 to \$12,000 an amended expenditure

Otherwise, costs to be reliable a bases for assessment maximums set formally advised costs due to direct expenditures v mum allowance statement.

Section 1720 the 1965-66 fiscal methods where in favor of the simplicity and ever, we have set forth in a

***Excess Cost Reports Reasonably Correct***

Considering the complexity of special education excess cost report forms and the fact that the accounting records are not designed to account for costs on a program or activity basis, we were favorably impressed with the effort expended by district personnel in seeing that the reports were correctly stated.

In our review of the eight school districts visited, two exceptions were noted, one resulting in an apparent overstatement of expenditures and the other in an understatement of expenditures. In the former, the school district was applying a weighted ADA factor in prorating certain indirect costs to special education. The use of weighted formulas, unless universally adopted, distorts comparisons of costs between districts and can result in incorrect conclusions as to the adequacy of state reimbursements if used in statewide studies.

Expenditures were understated in one district due to the district claiming reimbursement based only upon direct salaries and wages applicable to the special education programs. Obviously, other costs were incurred, the allocation of which is adequately explained in the school accounting manual. We estimate that an additional \$10,000 to \$12,000 could be claimed by this district if it filed an amended excess cost report.

Otherwise, costs reported by school districts were found to be reliable and, in our opinion, usable as guidelines or bases for ascertaining the adequacy of reimbursement maximums set forth in the Education Code. We were informally advised that many districts understate their costs due to districts "cutting short" their analyses of expenditures when they know they have exceeded maximum allowances. We found no evidence to support this statement.

Section 17200.5 of the Education Code, effective with the 1965-66 fiscal year, has limited to a large degree the methods whereby costs are to be allocated. We are strongly in favor of this legislation in that it provides for both simplicity and uniformity in accounting for costs; however, we have recommended certain technical changes as set forth in a later section of this report.

**State and District Share of Costs of Special Education**

Since the number of districts visited by the Auditor General's staff represented only a small number of the total districts in the state, we are unable to advise the Legislature of the relative shares of special education costs borne by the state and the districts on a statewide basis.

We have, however, prepared a tabulation of the excess costs per unit of ADA and percentages of excess costs applicable to those districts visited as shown in Schedule A.

This tabulation shows that high unit costs are incurred in the physically handicapped program, a major share of which is paid from district funds. The physically handicapped program costs are subdivided into subgroupings depending upon instruction methods, namely special class, remedial, individual instruction, etc.; costs by subgroupings are not shown in Schedule A.

Costs within the subgroupings vary substantially, (individual instruction, for example, may cost as high as \$4,000 per unit of ADA, whereas special physical education classes may be as low as \$553 per unit of ADA); however, the state's reimbursement is based upon the average unit cost of educating all physically handicapped; unit costs of educating the physically handicapped shown in Schedule A are a composite of all the subgroupings.

Costs of educating the educationally handicapped can also vary substantially. Costs of the learning disability group varies from a high of \$4,543 per unit of ADA to a low of \$583. Districts are reimbursed for costs reported for each subgroup of the educationally handicapped, rather than on a composite average cost of the subgroupings as is done with the physically handicapped.

It is our understanding that legislation will be introduced during the 1967 regular session reclassifying and regrouping certain of these classes to more equitably reimburse districts for costs incurred.

Taking into consideration only those districts visited, there appears to be a need for some adjustment in the state's reimbursement maximums applicable to the physically handicapped. The educationally handicapped program, a relatively new program, also shows that a substantial share of the cost is being borne by the districts. We believe that maximums should remain the same until

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**Levying and Accounting for Permissive Tax Overrides**

The review of school district records disclosed one instance in which the district prepared an incomplete report to the county superintendent of schools, resulting in the expenditure of \$39,000 of special purpose tax revenue for the education of nonspecial education pupils. These revenues should have been accounted for as restricted funds and reserved exclusively for the education of mentally retarded pupils.

All districts visited that levied permissive tax overrides for the education of the mentally retarded and the educationally handicapped **incorrectly** reported revenue and costs, **resulting in the collection of millions of dollars** of tax money contrary to our interpretation of the statutes.

Education personnel, in our discussions with them, generally agreed with our findings. For additional comments and an illustration of the district's reporting methods, see our comments on tax override levies under Findings and Recommendations which follow.

Detailed comments on our findings and recommendations follow:

**FINDINGS AND RECOMMENDATIONS****1. Relative Share of Fiscal Burden—State and Local Effort**

As indicated in this report, the review was too limited to determine the adequacy of the state's reimbursements to school districts for the education of the special child. We have concluded that excess cost reports prepared by school districts are reasonably correct. Copies of all district excess cost reports are on file with the Superintendent of Public Instruction.

The districts' reports can, in our opinion, be used as a basis to determine the share of state and local financial effort in the education of the special child. From an analysis of district excess cost reports, the Department of Education can ascertain those special education programs in which actual costs are at variance with statutory reimbursement maximums, and make appropriate recommendations to the Legislature for changes in statutory allowances.

Relative shares of fiscal burden might more simply be estimated by using the statewide average of direct teacher cost per unit of ADA as a basis. To illustrate, assume that the statewide averages for a particular special education program are:

Direct classroom teacher cost, including retirement	
OASDI, health and welfare, etc. -----	\$8,400
Overhead costs (reasonable percentage of direct costs, e.g., 20 percent) -----	1,680
Total estimated costs -----	10,080
Foundation program per standard ADA of 10 -----	2,500
Excess of estimated cost over foundation program -----	\$7,580
Excess cost per unit of ADA -----	\$758
Current statutory maximum allowance -----	670
District share of excess cost -----	\$88

It is assumed that the Department of Education will establish ADA standards for each special education program. We believe that computations similar to the above can be made by grade levels within subclassifications of the major program, if desired.

### Recommendation

We recommend that the Department of Education determine the relationship of costs borne by the districts and by the state, by programs, on a statewide basis, and that the department recommend adjustments in statutory maximum allowances for special education programs where they appear to be justified.

### 2. State Apportionment—Amounts and Methods of Payment

Districts and counties receive funds from the state for the excess costs per ADA of maintaining a special education program on a reimbursement basis limited to specified maximums as set forth in the Education Code. In determining the amount to be reimbursed, the state requires that districts file, annually, excess expense reports which show ADA by grade level and program and costs incurred, segregated by major classification of expense, program, and subclass within program. The reports are complex, require a great deal of analysis of district accounting records by local district personnel, and consume many

hours of departmental staff time prior to processing.

Under the present system, the amount of state aid is not determined until the year following the year in which the district does not finish the fiscal year until the second full first year of the fiscal year.

An apportionment of current year costs, terminating the fiscal year for current fiscal year programs.

### Recommendations

We recommend that the state based upon the following:

### 3. Small Class

Situations exist in some districts in which the number of students are few. In some districts will be low allowances for the total apportionment upon the basis of the number of students.

When it is necessary to conduct special education programs, and through the cooperation of the superintendent of state education, a necessary amount of state aid is necessary.

### Recommendations

We recommend that the state provide a grant of money for the necessary programs.

### 4. The Final Budgeting and Accounting

This report is based upon the district accounting records.

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Under the present system the amount of apportionment is not determined or disbursed until during the year following the year in which the costs are incurred. The state does not finance its share of the cost of new programs until the second year, which burdens the district with the full first year cost of new programs.

An apportionment based upon a fixed allowance per unit of current year's ADA would simplify the method of determining the amount of the apportionment and provide for current financing of current costs of special education programs.

#### **Recommendation**

We recommend that special education apportionments be based upon the current year costs.

#### **3. Small Class Allowances**

Situations occur in which special classes must, for reasons of geography or locale, be maintained by certain districts in which the number of special education students are few. In situations of this kind, costs borne by a school district will be substantially in excess of the state's allowances for the particular program. Under present law, the total apportionment received by a district is dependent upon the actual ADA for the particular program.

When it is not economically feasible for a district to conduct special education classes because of low enrollment, and no alternate facility is available, such as through contracting with another district, with county superintendents, or with private schools, a special allowance of state funds may be needed to adequately support a necessary small class in a district.

#### **Recommendation**

We recommend that the Legislature consider the feasibility of granting a special allowance to school districts for necessary small classes for special education programs where an alternate facility cannot be provided.

#### **4. The Final Report of the Citizens' Advisory Committee on School Budgeting and Accounting**

This report recommends many changes in school district accounting records, procedures, and reports. We gen-

erally agree with all of the committee's recommendations, particularly recommendations calling for program budgeting and cost accounting. There is little doubt that accounting for costs by activities and programs is vital to the effective management of school finances.

Under the present system, costs of special programs are determined from analysis of numerous expense accounts which require a great deal of documentation and supporting work papers. The accounts as prescribed in the accounting manual are not properly segregated and classified to permit recording of expenses in an expense account within a special program category.

In accordance with the school accounting manual, pupil transportation expenses are included in the current expense of education group of accounts. In our opinion, it is difficult to compare the current expense of education by school districts because of the inclusion in this category of expense the costs of transportation which vary greatly among school districts. Classifying pupil transportation expenses within a noncurrent expense of education category would result in more meaningful total current expenses of education and expenses per unit of ADA.

#### **Recommendation**

We recommend that school districts' accounting records be modified to provide for separate groups of accounts to record the costs of the several special education programs as well as the regular education program, and that the Department of Education study and develop guidelines by which this can be done economically and systematically throughout the state.

We recommend that pupil transportation be classified as an expense of operating a school district separate from current expenses of education.

#### **5. Allocation of Indirect Salaries and Wages**

Education Code Section 17200.5 specifies the methods of prorating salaries and wages applicable to special education programs. General administrative services are utilized in the operation of special education programs, but the code does not provide for the allocation of these indirect costs to special education programs, which results in the understatement of the costs of special education programs.

#### **Recommendations**

We recommend that salaries be amended to reflect the actual cost of the salaries of the personnel who are employed by the school districts.

#### **6. Part-Time Personnel**

Education Code Section 17200.5 provides that the salary of a part-time employee shall be based on the salary of a full-time employee whose code specifies the number of hours spent in the position. The Department of Education has not presented a report on the part-time personnel for the year 1970-71.

It is recommended that the Department of Education report on the part-time personnel for the year 1970-71. The report should include the number of part-time personnel, the salary of each, and the total salary for the year.

#### **Recommendations**

We recommend that the Department of Education report on the part-time personnel for the year 1970-71. The report should include the number of part-time personnel, the salary of each, and the total salary for the year.

#### **7. Permissible Expenditures**

School financing is based on the number of children in the state who are under the age of 18. The Department of Education has not presented a report on the number of children in the state who are under the age of 18 for the year 1970-71. The report should include the number of children in the state who are under the age of 18, the number of children in the state who are under the age of 18 who are handicapped, and the number of children in the state who are under the age of 18 who are in the education program.

Education Code Section 17200.5 provides that the salary of a part-time employee shall be based on the salary of a full-time employee whose code specifies the number of hours spent in the position. The Department of Education has not presented a report on the part-time personnel for the year 1970-71. The report should include the number of part-time personnel, the salary of each, and the total salary for the year.

**Recommendation**

We recommend that Section 17200.5 of the Education Code be amended to provide for the allocation of indirect salaries and wages to special education programs.

**6. Part-Time Certificated Salaries**

Education Code Section 17200.5 permits districts to include in their computations of the expenses of special education programs a portion of direct salaries of personnel whose duties are divided among several programs. The code specifies that salaries charged must be on a "time spent" basis and only upon "substantiated evidence being presented."

It is necessary that districts develop the detailed information for program accounting purposes and current reporting requirements; however, the requirement that detailed evidence be "presented" to the Department of Education creates undue burdens upon both the district and departmental personnel. One district submitted a formal report to the Department of Education consisting of 102 pages of payroll data which was of little value to the department.

**Recommendation**

We recommend that the Legislature amend Section 17200.5 of the Education Code to read "... upon substantiated evidence or documentation being readily available for audit in the school district."

**7. Permissive Tax Overrides**

School districts are permitted to levy overrides for the financing of certain special education programs. The education of the mentally retarded and the physically handicapped are statutory-mandated programs. A permissive tax override is permitted for the education of the mentally retarded but not for the education of the physically handicapped. Also, a tax override is provided for the educationally handicapped, which is not a mandated program.

Education Code Section 6913.1 (mentally retarded) and Section 20807 (educationally handicapped) permit the levy of the tax overrides; budget forms designed by the Department of Education include schedules whereby districts compute future year's tax revenue requirements for which the county board of supervisors levy the tax.

All districts included in the study that levied permissive tax overrides for the education of the mentally retarded and the educationally handicapped incorrectly reported revenue and costs, resulting in the collection of millions of dollars of tax money for restricted purposes which was used for other educational purposes.

Districts are excluding general purpose tax receipts applicable to special education pupils in their computation of permissive tax override requirements. It is our understanding that each child, whether handicapped or not, is entitled to a proration of the general purpose tax levy. By excluding a proration of general purpose taxes, school districts overstate the excess of expenditures over total revenue of special education, increasing the amount that will be raised from a permissive tax rate levied by the county board of supervisors.

It is generally agreed by education personnel that permissive tax overrides are intended by the Legislature to recover for school districts the excess of costs incurred in special education programs over the state's reimbursement for those programs and the amount available from other sources of district revenues.

The following illustrates the differences in computations using actual totals reported by a large sample school district and revised computations based upon our understanding of the legislation.

	Reported by district (In thousands of dollars)	Revised computation
Restricted balance, July 1, 1964-----	\$90	\$90
Tax receipts -----	645	645
State and federal apportionments -----	816	560
Other designated income -----	45	22
Restricted balance plus income -----	1,596	1,317
Actual expense -----	1,485	545
Restricted balance, June 30, 1965 -----	111	772
Estimated tax receipts on unsecured roll ----	95	95
Estimated state and federal apportionments --	835	532
Other estimated income -----	45	23
Restricted balance plus income -----	1,086	1,422
Amount budgeted for expenditure and transfer -----	1,600	650
Surplus (deficit) -----	\$(514)	\$772

The above statement reported that a district educational program tax override. On these special education applicable legislation \$1,000, a difference by the school district.

The revised computation presenting excess costs exclusively for special education available for transportation, there is a surplus of \$772.

### Recommendations

We recommend that the Legislature amend the tax override and transportation provisions to require that such overrides be used exclusively for special education purposes.

### 8. Forms Revision

In the illustration of the budget form, the line entry to account for the restricted balance of the year's budget is the next year's budget. The forms can and should be revised to show the reported balances of the restricted balance for special education purposes with the following year's budget.

### Recommendations

We recommend that the Legislature amend the accounting provisions to disclose the accounting for the restricted balance occurring in the following year's budget.

### 9. Budgetary Control

Section 1835 of the Illinois School Code requires that the unexpended balance of the school service fund be used for any activity or program of the school district.

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The above statement shows that the sample district reported that a **deficit of \$514,000** was expected in special educational programs requiring the levy of a permissive tax override. Our recomputation of the funds available for these special educational programs, as we interpret the applicable legislation, shows a projected **surplus of \$772,000**, a difference of \$1,286,000 from the deficit projected by the school district.

The revised computations show only those totals representing excess expenses and state apportionments made exclusively for this purpose. If, as shown, the resources available for these excess costs exceed the excess expenses, there is no need for a special tax levy.

**Recommendation**

We recommend that the policy regarding the use of overrides and the method of determining the amount of such overrides be reviewed.

**8. Forms Revision--Permissive Tax Override Levies**

In the illustration shown in the preceding comments, the budget form as reproduced does not provide a separate line entry to account for adjustments which may occur in the restricted balance between the date that a particular year's budget is prepared, districts books are closed, and the next year's budget document is due. Major adjustments can and do occur. An additional line entry in the form showing adjustments to the preceding year's reported balances can provide a means whereby ending restricted balances of one year can be identified for control purposes with adjusted beginning restricted balances in the following year.

**Recommendation**

We recommend that school district budget documents accounting for permissive tax override levies be revised to disclose adjustments, if any, in restricted balances occurring between years.

**9. Budgetary Control by Line Items**

Section 18351.1 of the Education Code requires that unexpended balances of an approved budget of a county school service fund be controlled by line items in each activity or program. It further requires that amounts ex-

pendent in excess of the approved budget be withheld from the allowances made in the next succeeding fiscal year. Preparation, review, approval, and posting of budget changes consume many hours of personnel time at the county and state levels; many of the documents merely transfer small amounts between line items within the same overall program.

### Recommendation

We recommend that control by the Department of Education over county school service fund budgets be limited to review of the overall activity or program instead of line items.

### Schedule A

#### Summary of Special Education Program Excess Costs of Selected School Districts For the Year Ended June 30, 1965

Program	State's share		District's share		Total excess cost
	Cost per ADA	% of total	Cost per ADA	% of total	
<i>Physically handicapped</i>					
School district					
A -----	\$927	72%	\$361	28%	\$1,288
B -----	918	73	333	27	1,251
C <sup>1</sup> -----	910	66	462	34	1,372
D <sup>1</sup> -----	910	52	827	48	1,737
E <sup>2</sup> -----	720	100	—	—	720
F -----	967	53	865	47	1,832
G -----	912	68	420	32	1,332
H -----	910	95	52	5	962
County superintendent of schools:					
Elementary -----	658	100	—	—	658
Secondary -----	675	100	—	—	675
<sup>1</sup> Total costs overstated in relation to other districts due to application of weighted ADA factors.					
<sup>2</sup> Reported direct salary costs of instruction only.					
<i>Educable mentally retarded</i>					
School district					
A -----	375	84	72	16	447
B -----	375	85	64	15	439
C -----	375	67	181	33	556
D -----	375	77	113	23	488
E -----	68	100	—	—	68
F -----	375	66	191	34	566
G -----	299	100	—	—	299
H -----	375	97	13	3	388
County superintendent of schools—elementary	375	55	307	45	682

<sup>1</sup> Total costs overstated in relation to other districts due to application of weighted ADA factors.

<sup>2</sup> Reported direct salary costs of instruction only.

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*Trainable ment*  
School district  
A -----  
B -----  
G -----  
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County superintendent of schools

*Educationally*  
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School district  
A -----  
B -----  
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*Learning disab*  
School district  
A -----  
B -----  
G -----  
County superintendent of schools

*Home and hos*  
School district  
A -----  
B -----  
F -----  
G -----  
County superintendent of schools

*Transportation handicapp*  
School district  
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Program	State's share		District's share		Total excess cost
	Cost per ADA	% of total	Cost per ADA	% of total	
<i>Trainable mentally retarded</i>					
School district					
A -----	\$670	94%	\$40	6%	\$710
B -----	670	76	209	24	879
G -----	670	94	46	6	716
H -----	670	88	91	12	761
County superintendent of schools—elementary	595	100	—	—	595
<i>Educationally handicapped</i>					
<i>Special day classes</i>					
School district					
A -----	290	100	—	—	290
B -----	910	96	37	4	947
G -----	910	85	165	15	1,075
H -----	910	52	849	48	1,759
<i>Learning disability groups</i>					
School district					
A -----	715	100	—	—	715
B -----	910	20	3,633	80	4,543
G -----	910	57	700	43	1,610
County superintendent of schools—elementary	583	100	—	—	583
<i>Home and hospital instruction</i>					
School district					
A -----	650	100	—	—	650
B -----	910	47	1,012	53	1,922
F -----	910	94	62	6	972
G -----	910	57	690	43	1,600
County superintendent of schools—elementary	150	100	—	—	150
<i>Transportation—certain handicapped pupils</i>					
School district					
A -----	455	100	—	—	455
B -----	305	100	—	—	305
C -----	475	73	176	27	651
F -----	475	81	113	19	588
G -----	421	100	—	—	421
H -----	420	100	—	—	420
County superintendent of schools—elementary	358	100	—	—	358

## CHAPTER ELEVEN

### FINAL NOTES

#### ACCOUNT RECEIVABLE FROM DEL NORTE COUNTY

The Auditor General's review of the School Land Fund for the year ending June 30, 1965, revealed that **Del Norte County** owed the fund a total of **\$350,600** as of the end of that fiscal year.

This figure represents the balance due of amounts allocated to the county by the State Allocations Board from funds appropriated under Item 398.6 of the 1962 Budget Act, plus unpaid interest of \$1,984. The appropriation provided \$350,000 for construction of jails.

The act provides that:

"If funds are allocated to a county under this item, the Controller shall transfer to the State School Land Fund each payment due to the county under Section 25761 of the Business and Professions Code, until there has been deducted from such payments an amount equal to the amount allocated to the county under this item, together with interest at a rate not to exceed 3½ percent annually."

Payments due to a county under Section 25761 of the Business and Professions Code relate to the distributive share of liquor license fees.

In the case of Del Norte County, the distributive share has amounted to \$10,208; \$9,055; \$11,162; \$11,226; and \$11,165 for the five fiscal years preceding our report.

These amounts are not sufficient to pay interest charges at 3½ percent, and also to make repayments on the principal. Annual interest on the principal balance of \$348,616 amounts to \$12,201.56.

In its resolution allocating the funds to Del Norte County, the State Allocations Board provided that "the allocation made herein shall be repaid in accordance with the provisions of the act, or in such manner as may be provided by future legislative action."

It appears that unless the Legislature provides for some additional method of repayment by Del Norte County, this loan will not be repaid.

**STATE SCHOOL FUND (OVERPAYMENTS TO SCHOOL DISTRICTS)**

While in process of auditing the State School Fund for the year ending June 30, 1966, the Auditor General's staff found that errors in computing apportionments resulted in **overpayments** to the following school districts:

School district	Amount
San Diego Unified .....	\$253,470
Sacramento City Unified .....	12,000
Coronado Unified .....	12,000
Lompoc Unified .....	9,000
Davis Joint Unified .....	4,000
Eureka .....	3,500
Folsom Joint Unified .....	3,500
Total .....	\$297,470

The junior high school summer school ADA was not excluded in computing the adjusted ADA for the second principal apportionment to the above districts, thus creating the error.

An error was made also in computation of ADA for the San Francisco Unified School District, but this did not result in an overpayment. San Francisco Unified qualifies only for basic aid, and is eliminated from the second principal apportionment.

ADA computations for all larger school districts that conduct junior high school summer classes were examined, and we made the following recommendations to the Bureau of School Apportionment:

- (1) Recompute the second principal apportionments for the school districts named above, and notify the State Controller to withhold the overpayments from subsequent apportionments.
- (2) Review ADA computation for school districts conducting junior high school summer classes that were not examined by the auditors, and make adjustments as recommended under No. 1 above.
- (3) Review the computation of ADA used in the derivation of the State School Fund for the 1966-67 fiscal year.

During the course of the examination the Auditor General's Staff reviewed the controls over data-processing input and found a number of errors requiring correction. We have brought this information to the attention of appropriate personnel.

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**DEPARTMENT OF SOCIAL WELFARE--GENERAL FUND ACCOUNTS**

In connection with the audit of the General Fund of the State of California for the year ending June 30, 1966, the Auditor General made an examination of the General Fund accounts administered by the Department of Social Welfare for that year.

During the examination the matters discussed in the following paragraphs were noted.

**Medical Assistance Advances to Counties**

The June 30, 1966, financial statements as originally submitted to the State Controller showed \$7.5 million in advances to counties for medical assistance purposes. However, effective March 1, 1966, the counties were instructed to file their medical assistance expenditure reports with the Health Care Deposit Fund.

The effect of this, is that while advances were made out of the General Fund, claims for reducing the advances were filed with the Health Care Deposit Fund.

Adjusted journal entries for statement purposes, which reduced advances and increased expenditures, were given to the State Controller for inclusion in his 1965-66 fiscal year annual report. However, the entries to show these adjustments have not been made in the accounting records.

We have recommended that entries be made in the General Fund records of the Department of Social Welfare to state correctly the advances and expenditures as of June 30, 1966. Also, that formal entries be given to the State Controller so he may correct his accounting records.

**Reimbursements**

Approximately \$200,000 of medical assistance program costs were not claimed from the Social Welfare Federal Fund. Most of this amount had been computed in the costing process, and was stated separately in the cost summaries.

Representatives of the Department of Social Welfare informed us that this amount had been overlooked. However, it had still not been claimed when the Auditor General's staff completed their examination of the accounts of the department for the year ending June 30, 1966.

We have recommended that a claim be submitted for reimbursement of medical assistance program costs incurred during the 1965-66 fiscal year, but not yet claimed from the Social Welfare Federal Fund.

**Accounts Receivable—Stipends**

Welfare employees, state or county, may be granted stipends in order to further their education. When recipients do not fulfill the contractual arrangement, they are required to pay back amounts received. Receivables, fully reserved, are established when it is determined that stipend recipients must make restitution.

In the review of these receivables the following discrepancies were noted:

- (1) Some receivables amounting to approximately \$10,000, or about 20 percent of the total involved, were not recorded.
- (2) The number of delinquent accounts is extremely high.
- (3) The followup by the department on delinquent accounts is extremely poor.

We have recommended that the department analyze the stipends receivable account, and maintain it on a current basis. We have recommended also that the department improve its followup procedures in collecting amounts due to the state.

**Federal Share of Costs**

The Social Security Amendments of 1965 gave states with approved medical assistance programs the option of shifting to a straight 50-50 sharing relationship with the federal government.

The State of California has elected the 50-50 sharing basis for the period January 1 to June 30, 1966. However, the effect of this election was not included in the June 30, 1966 financial statements.

The Department has made calculations which show the effect of the new sharing basis on the federal government and the state for categorical aid expenditures between January 1 and June 30, 1966. However, no comparable calculation has been made for the medical expenditures during the same period.

Based on the department's categorical aid calculations and on an approximation of the revised medical cost sharing basis, we estimate that expenditures for the year ending June 30, 1966 are **overstated by \$2 million.**

We have recommended a calculation and the state as a result.

**Limitation on Expenditures**

Section 8 of the extraordinary Session obligation for 1965-66 fiscal year.

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**DEPARTMENT C**

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**Unclaimed Federal Funds**

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We have recommended that the department complete its calculation and determine the actual amount gained by the state as a result of the 50-50 sharing election.

**Limitation on Expenditures**

Section 8 of Chapter 4, Statutes of 1965 (Second Extraordinary Session) established a limitation on the state's obligation for all phases of public assistance during the 1965-66 fiscal year.

Representatives of the department have informed us that figures were not accumulated to determine whether Section 8 had been complied with. We have recommended that the department make the required computations.

**DEPARTMENT OF REHABILITATION—GENERAL FUND ACCOUNTS**

As part of the examination of the financial statements of the General Fund of the State of California for the year ending June 30, 1966, the Auditor General has examined the General Fund accounts maintained by the Department of Rehabilitation for that year.

The review disclosed a number of deficiencies in accounting records and procedures. These deficiencies were discussed with agency personnel during the course of the audit.

**Unclaimed Federal Funds**

The department **did not claim approximately \$130,000 of federal funds** it was entitled to for expenditures, under cooperative programs, with other departments and local school districts.

Under the agreements, these other departments and school districts certify to the Department of Rehabilitation the expenditures made for vocational rehabilitation which are eligible for federal reimbursement.

Certifications of \$620,000 were submitted to the department during the year, but the department used only \$411,000 of this amount in claiming federal reimbursement. Based on the federal participation rate of 62.9 percent, the state could have recovered an additional sum in excess of \$130,000 if the total amount of certifications had been claimed.

Administrative employees informed us they were claiming only those amounts sufficient to reimburse the department for its own expenditures. We have not seen any definite statement that amounts recoverable from the federal government are to be so limited.

In the section under method of financing, the cooperative agreement between the Department of Rehabilitation and the Department of Mental Hygiene for a vocational rehabilitation program at DeWitt State Hospital states:

"Since this Vocational Rehabilitation Program will be an integral part of the service program of the Department of Rehabilitation and will operate under its direction (as provided in the cooperative agreement), the Program will be financed in the same manner as are the other functions of the Department, namely, through the use of Federal and State matching funds as required under Section 2 of Public Law 565 of the Federal Vocational Rehabilitation Act, and as provided in the California State Plan for Vocational Rehabilitation."

If all expenditures are made by the Department of Rehabilitation, and if these cooperative programs are an integral part of the department's service program we believe that the expenditures should be reported to the federal government. We have seen no evidence that the federal government would reject such additional claims.

As another reason for not claiming full expenditures, department personnel have stated they are waiting for federal audits to be made. We believe the department should make provisions to verify the accuracy and authenticity of expenditures reported by cooperating agencies, and discuss questions of allowability with federal administrators without waiting for federal audit.

Since the 1963-64 fiscal year, the department has been claiming 50 percent of the cost of field rehabilitation services from the federal government. The federal government took exception to the 1963-64 charge on the basis that the charge should have been only 15 percent.

In reply to the federal government, the department stated that 1964-65 and 1965-66 percentages were maintained at 50 percent, although the actual percentages for those years were 58 percent and 76 percent.

We have seen calculations only in support of the 1965-66 percentage. However, if the department's figures are correct and the federal government's percentage for 1963-64 is accepted, the department has **underclaimed approximately \$36,000** in federal reimbursements.

#### **Administrative P**

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Department of Education programs are an important part of the vocational rehabilitation program. The Department of Education is waiting for the Department of Education and the State of California to be able to claim the federal share of the vocational rehabilitation program.

Department of Education has been waiting for the State of California to be able to claim the federal share of the vocational rehabilitation program. The Department of Education is waiting for the State of California to be able to claim the federal share of the vocational rehabilitation program.

#### Administrative Pro Rata Charges

The State of California has a contingent liability of approximately \$470,000 to the federal government for pro rata administrative charges. The Department of Rehabilitation and the Department of Education charged this amount to the federal government as costs of rehabilitation programs during the period July 1, 1954-June 30, 1966.

Federal auditors have taken exception to these charges, but the state has not returned the amounts involved to the federal government. The disagreement is of long standing, and evidently affects other states as well as California.

We understand the matter is under discussion between officials of the U.S. Department of Health, Education, and Welfare and officials of the various states. If a decision favorable to the federal government is made, the State of California may have to refund the maximum amount.

An opposite situation exists for the period July 1, 1943-June 30, 1951. At this time, pro rata charges were disallowed by federal auditors, and were not collected from the federal government. These represent contingent amounts due from the federal government, and equal \$70,000 to \$80,000.

The department maintains fully reserved receivable accounts for a small part of these disputed transactions in the Vocational Rehabilitation Federal Fund. However, as we described in our report on this fund, the accounts are incomplete and incorrect.

The disputed amounts constitute contingent assets and liabilities of the State General Fund, and we believe they should be recorded in memorandum form in the General Fund records until a settlement is reached.

The department did not claim federal funds of \$25,850 for the federal share of state administrative pro rata charges incurred during the year ending June 30, 1966. These costs were not reported as expenditures to the federal government, and were omitted on the basis that federal auditors would reject them.

We believe these charges are part of the cost of the vocational rehabilitation program and should be claimed, collected, and recorded.



**Disallowed Rent—Office Space**

Office space in the San Francisco State Office Building is provided free of charge to General Fund agencies. The Department of Rehabilitation did not have actual billings to claim, and for federal participation purposes claimed an amount based on normal state office rental charges for the space it occupies in the building. For the period July 1, 1963, to June 30, 1966, the federal share claimed was \$31,983. The federal government has taken exception to this charge.

We have recommended that the department apply for a retroactive amendment to the state plan. This should provide for costs of service and maintenance in lieu of rent. The necessary cost data can be supplied by the Department of General Services to support charges for office space, and these should overcome the objections of federal auditors.

**Accounting Procedures and Internal Control**

During the examination weaknesses in internal controls and accounting procedures were noted. Improvement is needed in the area of equipment accounting, control of trainee equipment, payroll records and procedures, expenditure accounting and procedures, and accounting record correction procedures.

We have made a number of recommendations to the department on these subjects, and we believe prompt correction is required.

**SAN QUENTIN STATE PRISON—GENERAL FUND AND  
INMATE TRUST FUND ACCOUNTS**

In connection with the Auditor General's examination of the General Fund of the State of California for the year ending June 30, 1965, a review was made of General Fund accounts and Inmate Trust Fund accounts administered by the State Prison at San Quentin.

During this review, the Auditor General's staff found a number of instances of careless work indicating either a basic lack of knowledge or lack of interest on the part of clerical and supervisory personnel in the accounting office.

While the errors resulting from the careless work are not of major importance in dollars, we believe it is important to determine and correct the causes.

**General Fund**

The Auditor's examination of the General Fund accounts, which is a State Control, was not recorded by the department.

Instead, during 1965 the agency failed to amortize cash balances. The amount was \$31,983.

The agency failed to determine its cash balance. The check for \$57,000 was being released. Instead, the amount was \$31,983.

In 1963, an amount of \$25,000 was reduced by \$25,000. The amount was \$31,983.

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**General Fund**

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The Auditor General's staff found that bank reconciliations, which should account for differences between the State Controller's balances of cash on deposit, and those recorded by the agency, do not account for all such differences.

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Instead, during the last several months of fiscal year 1965 the agency reconciled the State Controller's balances to amounts different from the agency's recorded cash balances. No explanation was given for using these unidentified balances.

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The agency had cash on hand amounting to \$41.01. This amount was unrecorded, because the agency could not determine its composition. Additionally, a revolving fund check for \$57.38 was issued in March 1964 to an inmate being released. However, the inmate was not released and the check was not redeposited in the revolving fund. Instead, the check was deposited in the cash state account with no adjustment being made.

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In 1963, an advance of \$4,000 to the Architecture Revolving Fund for an equipment addition was later reduced by \$255.99 with a State Controller's transfer closing the completed work order.

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However, the agency did not close the remaining \$3,744.01 advance and capitalize the equipment addition in spite of the statement on the transfer notice that the work order was being closed.

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Two other advances to the Architecture Revolving Fund were closed early in 1965, but the related improvements were not capitalized until later in the year. An advance of \$242,535 was closed in May 1965, but not capitalized until August 1965. Another advance of \$19,136 was closed in January 1965, but not capitalized until October 1965.

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We believe it is desirable to capitalize improvements concurrently with the closing of related advances to the Architecture Revolving Fund. This prevents overlooking the proper recording of improvements.

In June 1965, the property additions were recorded as \$8,269 but this figure was actually the total of credits to be made to the account for the month. The additions amounted to \$17,921, and the error was not detected because the general ledger control account was not checked with the detail property records.



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We recommend that the quality of accounting work being done at the agency be reviewed and improved by responsible supervisory personnel. The Department of Corrections has informed us recently that procedures and practices have been improved, and records are more complete and accurate than at the time of this audit.

**CALIFORNIA MEDICAL FACILITY AT VACAVILLE—GENERAL FUND AND TRUST ACCOUNTS**

In connection with the Auditor General's examination of the General Fund of the State of California for the year ending June 30, 1965, an examination was made of the General Fund and trust accounts administered by the California Medical Facility at Vacaville.

During the examination, a number of deficiencies in account procedures were observed.

**General Fund**

During the 1964-65 fiscal year, several documents showing transfers of funds and other adjustments received from the State Controller's office had not been recorded, or had been recorded incorrectly, by the institution.

These errors resulted in a difference of \$10,045 between prior year appropriation adjustments recorded by the institution, and those reported by the State Controller.

The balance of \$2,930 in the reserve for uncleared collections account at June 30, 1965 included uncleared receipts dating back to 1961. No procedure to follow up on receipts which cannot be credited promptly to the proper accounts was in effect.

Included in the accounts receivable balance at June 30, 1965, was an uncollected billing of \$9,072 from the preceding fiscal year. This figure represented the cost of furnishing two guards for inmates who had volunteered to participate in a research project concerning dietary requirements for men on space flight missions.

The National Aeronautics and Space Administration granted \$412,452 to the Medical Sciences Research Foundation for the dietary research project, and the foundation in turn arranged certain services with the Molano Institute for Medical and Psychiatric Research.

The institute was under the direction of the Superintendent of the California Medical Facility, and he ar-

ranged for inmates of the facility to participate in the experiment.

However, no signed contract bound NASA or either research organization to pay for the guard services provided by the California Medical Facility. Efforts to collect the \$9,072 cost involved have been unsuccessful.

We have recommended that the institution apply to the Board of Control for relief from accountability for this account receivable, which appears to be uncollectible.

We have also recommended that the institution follow provisions of Section 1201 of the *State Administrative Manual* when entering into contracts where state funds are involved.

#### **Trust Accounts**

Deposit balances of \$2,869 were on hand at June 30, 1965, for former inmates who have been dead for more than one year, or paroled or discharged for more than seven years. Sections 19425.1 and 19425.2 of the *State Administrative Manual* provide that such balances be remitted to the State Treasurer for deposit in the Unclaimed Property Fund.

The mail room prepares "receipts" for cash received by mail, which are sent with the cash collections to the cashier. This method of operation does not provide satisfactory controls. Instead, a listing of cash collections should be sent directly to the Trust Office for posting and checking against the cashier's deposits.

The Department of Corrections has replied to this report, and is taking steps to improve procedures at the California Medical Facility in line with our recommendations.

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**CHAPTER TWELVE**

**THE JOINT LEGISLATIVE AUDIT COMMITTEE**  
**and**  
**THE OFFICE OF THE AUDITOR GENERAL**

An independent postaudit service for the executive and legislative branches of California state government was established by the 1955 session of the State Legislature.

Senate Bill No. 1540, enacted as Chapter 1699, Statutes of 1955, added Chapter 4 to Part 2, Division 2, Title 2, of the California Government Code. The chapter is covered by Sections 10500-10528 of the California Government Code, and is reproduced in Appendix B of this report.

In 1955, the Legislature recognized the need for two types of auditing in state government—an internal audit and an independent postaudit.

The internal audit is conducted within the executive branch of state government, and is designed to meet the need for periodic and special audits of revenues and expenditures. In addition, this type of audit monitors accounting and reporting systems within state agencies. The internal audit is recognized as a means of insuring the proper and lawful expenditure of state funds, and the Legislature expressed the desire that this function be coordinated in the executive branch to promote better economy and efficiency.

In contrast, the independent postaudit has been placed outside the executive branch under the policy direction and control of a legislative committee. It had become apparent by 1955 that state government needed the same useful and independent annual appraisal large private corporations receive from national accounting firms. The postaudit program created at this time was designed to meet the need for such an independent review.

**Joint Legislative Audit Committee**

The Joint Legislative Audit Committee consists of three members of the State Senate and three members of the State Assembly. Members of the committee are selected under provisions of the Joint Rules of the Senate and Assembly. The Joint Rules provide that Senate

members shall be appointed by the Senate Committee on Rules, and Assembly members shall be appointed by the Speaker of the Assembly.

Chapter 1699, Statutes of 1955, specifies that the Joint Legislative Audit Committee shall have continuing existence and that it may meet, act, and conduct business at any place within the state. This applies during the sessions of the Legislature or any recess thereof, and in the interim period between sessions.

The duties and responsibilities of the committee are to appoint an Auditor General and a Deputy Auditor General, to determine the policies of the Office of the Auditor General, ascertain facts, review reports and take action thereon. In addition, the committee is required to make recommendations to the Legislature concerning the state audit, revenues and expenditures of the state, its departments, subdivisions, and agencies.

The committee is authorized to make rules governing its own proceedings. It may also establish subcommittees from its membership and assign to such subcommittees any study, inquiry, investigation, or hearing which the committee itself has authority to undertake or hold.

The committee has the powers and authority granted to investigating committees by Joint Rule 36 of the Senate and Assembly. This rule provides that a committee may fix rules governing its procedure, may employ such assistants as may be necessary, and shall be empowered to subpoena witnesses. Under this rule every department and agency of the state government, and every political subdivision of or in the state, is required to furnish a committee such information or records as the committee deems necessary for the accomplishment of its purpose. The rules adopted by the Joint Legislative Audit Committee to govern its procedure are contained in Appendix E of this report.

#### OFFICE OF THE AUDITOR GENERAL

The permanent office of the Auditor General is designated as Sacramento and provisions are made for the establishment of offices in other places when in the judgment of the Auditor General they are required for the conduct of the work. No other offices have been established.

The Auditor General has access to all state books, accounts, agency of the state or otherwise.

It is the duty of the Auditor General to report annually to the Legislature on the operations of the state in accordance with the principles and policies of the preceding fiscal year.

The Auditor General is authorized to make investigations of the operations of the state and to make recommendations to the Legislature on the basis of his judgment.

It is also the duty of the Auditor General to request the Legislature to take action on his recommendations.

The Auditor General and his staff are certified by the Legislature.

#### Auditor General's Office

The Auditor General's Office is composed of the Auditor General, the Deputy Auditor General, and two part-time employees.

Auditor General  
Deputy Auditor General  
Office staff

Total

The committee's report for 1966, was as follows:

#### Class

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Junior accountant

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The Auditor General and the Deputy Auditor General are certified public accountants.

**Auditor General's Staff**

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The roster of the Office of the Auditor General at December 31, 1966, included 33 full-time employees and two part-time employees. The roster of full-time employees is summarized as follows:

Auditor General and Deputy Auditor General	2
Audit staff	29
Office staff	2
Total	33

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The composition of the audit staff at December 31, 1966, was as follows:

Class	Total	CPAs
Audit managers	3	3
Audit supervisors	3	3
Senior accountants	6	4
Semisenior accountants	8	3
Junior accountants	9	—
Total	29	13

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There was an increase of one in the number of full-time accountants during the two-year period ended December 31, 1966. In addition to the staff members shown above, one employee is serving in the armed forces.

The audit staff of the Office of the Auditor General has been recruited on an exempt (non-civil-service) basis, as directed by the Joint Legislative Audit Committee and as permitted by the Joint Rules of the Senate and the Assembly.

The high standards which were established at the beginning for the recruitment of audit staff members have been consistently maintained. These standards are:

A bachelor's degree or higher with a major in accounting from a recognized college or university;

Possession of a certified public accountant's certificate, at least at the higher staff levels;

The ability to work with others on a professional plane;

A high degree of personal integrity; and

An unusual amount of curiosity, industry, perseverance, and resourcefulness.

A condition of employment on the audit staff is that a member will obtain a certificate as a certified public accountant within a reasonable time after joining the staff. This condition provides reasonable assurance that there will be a continuation of the education of the staff member, which benefits the legislative audit program as well as the staff member.

#### **Audit Policy**

In adopting an audit policy for the Office of the Auditor General, the committee placed special emphasis on the following quotation taken from a report issued in 1954 on auditing and accounting in the government of the State of California by a recognized national firm of certified public accountants:

"As to the duties and functions of the office: the auditor should have the primary duty, and necessary authority, to examine and report annually upon the financial statements of the State; such statements should be required to be furnished to him by the Director of Finance, the State Controller and State Treasurer or other princi-

pal accountants. The annual examination of the department's selection of the auditors should be made such that the committee believes desirable. . . .

"The audit should be conducted independently. The recommendations to make but not should be legislative action.

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pal accounting officials. This should not require the an-  
nual examination of the statements and accounts of each  
department or agency; the scope of the work and the  
selection of the agencies should be left to the discretion  
of the auditor and his counseling committee. He should  
make such other examinations or investigations as he  
believes desirable and those he is directed to perform by  
the committee only, or the Legislature acting through  
it. . . .

"The auditor's authority, beyond that of examining,  
should be confined to reporting objectively and inde-  
pendently. The reports should include such comments,  
recommendations and suggestions as the auditor wishes  
to make but he should have no power to enforce them  
nor should he otherwise influence or direct executive or  
legislative action. . . .

"The objectives of these examinations are given in the  
definition of the term 'auditing' which was set forth  
earlier in this section; restated briefly they are to ascer-  
tain:

"That the executive branch is carrying out only  
the activities and programs authorized by the Legis-  
lature and is doing so effectively and efficiently.

"That expenditures are made and revenues are  
collected in accordance with the laws and regulations.

"That the assets of the State are safeguarded and  
utilized properly.

"That the reports and financial statements pre-  
pared by the executive branch disclose all material  
information necessary to a proper evaluation of the  
State's activities."

There has been no change in this audit policy since its  
adoption.

To assure that this policy is carried out, the Joint  
Committee has the Auditor General submit a tentative  
program of audits each year for approval. The programs  
carried out by the Office of the Auditor General have  
been changed in emphasis to meet the particular needs  
of the Legislature and management. Investigations were  
made at the beginning into the effectiveness of the sys-  
tems of internal control in most of the state agencies to  
determine the extent of the tests to which audit pro-  
cedures could be restricted. Internal control procedures

are reviewed on the occasion of each new audit of an agency.

The audit emphasis has been shifted from time to time from funds, which are the accounting entities, to agencies and back to funds. The only state funds not audited by the Auditor General are the Compensation Insurance Fund, which is audited each year by internal auditors from the Department of Finance, and the Veterans Farm and Home Building Fund, which is audited by a firm of independent certified public accountants. The only state agency that has not been audited by the Auditor General is the University of California. The university is audited annually by an independent firm of certified public accountants. Reports on the audit of the university are submitted each year to the Auditor General.

The Legislature passed legislation during the 1965 session which would have amended the statutes to provide for the audit of the Compensation Insurance Fund by the Auditor General instead of auditors in the Department of Finance. This legislation was vetoed by the Governor. It is the opinion of the joint committee that the insurance-buying public would be better protected by an independent audit of this executive branch agency by an audit group outside the executive branch of the government.

The Auditor General has made an audit of the General Fund of the state each year beginning with the year ended June 30, 1963. For each year during this period as many audits as possible have been made of the other government cost funds (those in which the cost of government services to the public are recorded), working capital funds, public service enterprise funds, bond funds, general debt service funds, and trust funds.

Much of the work in connection with the audit of funds is done in the Office of the State Controller. However, it is necessary also to examine on a test basis the records of the state agencies in which transactions originate to satisfactorily complete an audit of a fund. In the audits performed by the Auditor General, statistical sampling is used as an audit technique wherever possible to determine the minimum audit sample that will produce an acceptable degree of reliability and thereby maximize the audit coverage with a limited size audit staff. The com-

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#### REPORTS R

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of the audit staff in computer training courses to advance  
their knowledge in this field. This special knowledge of  
computers permits their use as audit tools in special  
situations.

REPORTS RECEIVED AND REVIEWED BY THE COMMITTEE

The reports which have been received from the Office  
of the Auditor General during the four-year period from  
January 1, 1963, through December 31, 1966, are listed in  
Appendix A. Included in this list are 153 reports which  
were received by the joint committee during the two years  
ended December 31, 1966. These reports are classified as  
follows:

Reports on examinations of the financial statements of state funds -----	55
Reports on examinations of the accounts of state agencies -----	66
Reports on special investigations -----	32
Total -----	153

The Legislative Reference Service has copies of re-  
ports on examinations of financial statements of state  
agencies and funds and reports on special investigations  
issued by the Auditor General.

Reports on Examinations of Financial Statements of State Funds

The reports on examinations of financial statements of  
state funds received from the Office of the Auditor Gen-  
eral contain "scope" and "opinion" paragraphs recom-  
mended by the American Institute of Certified Public  
Accountants for use by firms of certified public account-  
ants in reporting on audits of client organizations. These  
paragraphs, modified for reports on governmental audits,  
are as follows:

Scope

We have examined the balance sheet of -----  
fund of the State of California as of June 30, 19\_\_\_,  
and the related statement of revenues, expenditures,  
and unappropriated surplus for the year then  
ended. Our examination was made in accordance  
with generally accepted auditing standards and ac-  
cordingly included such tests of the accounting rec-

ords and such other auditing procedures as we considered necessary in the circumstances.

### Opinion

In our opinion, the accompanying balance sheet and statement of revenues, expenditures, and unappropriated surplus present fairly the financial position of \_\_\_\_\_ fund of the State of California as of June 30, 19\_\_\_\_, and the results of its operations for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year and with applicable state laws.

These paragraphs contain three terms which have technical meaning. The meanings of the terms "generally accepted auditing standards" and "generally accepted accounting principles" as supplied by the Auditor General are shown in Appendixes C and D, respectively. During 1966 the administration adopted the accrual basis of accounting, referred to in item 11 of Appendix D, to be effective as of June 30, 1967.

The term "examination" means a critical analysis of the underlying internal controls and accounting records of an operating entity of sufficient scope to warrant the expression of an opinion as to the propriety of the financial statements prepared from those records. To examine the financial statements of funds of the State of California, the Office of the Auditor General must make this critical analysis of the accounting records of the operating agencies where the financial transactions originate as well as the control accounts maintained by the State Controller, and review the controls established over transactions by the agency being audited as well as the controls exercised by central control agencies of the state.

In the performance of these examinations, the staff of the Office of the Auditor General meets the tests of the generally accepted auditing standards set forth in Appendix C. The Auditor General has an adequately trained staff which maintains a proper independence in mental attitude toward its tasks and uses due professional care in the performance of its work.

Further, the Auditor General in the performance of these examinations determines whether the accounting

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records of the state agencies are maintained in accord-  
ance with generally accepted accounting principles as set  
forth in Appendix D.

The fourth reporting standard shown in Appendix C  
requires that "the report shall either contain an ex-  
pression of opinion regarding financial statements taken  
as a whole, or an assertion to the effect that an opinion  
cannot be expressed." In complying with this reporting  
standard, the Auditor General has followed the rule of  
the American Institute of Certified Public Accountants  
that a member shall not permit his name to be associated  
with statements purporting to show financial position or  
results of operations unless he:

- (a) Expresses an unqualified opinion; or
- (b) Expresses a qualified opinion; or
- (c) Expresses an adverse opinion; or
- (d) Disclaims an opinion on the statements taken as  
a whole and indicates clearly his reasons therefor.

The auditor qualifies his opinion on financial state-  
ments because he has a reservation about them that pre-  
cludes his expressing an unconditional opinion. The res-  
ervation must be material to warrant its expression, but  
not material enough to negate his opinion on the state-  
ments as a whole. Examples are a limitation on the scope  
of the examination, or a departure from observing gen-  
erally accepted accounting principles in recording ac-  
counting transactions.

An adverse opinion is expressed when the exceptions  
as to the fairness of the presentation of financial infor-  
mation in the auditor's judgment are so material that  
the expression of a qualified opinion is not justified. The  
adverse opinion states that the financial statements do  
not fairly present the financial position and the results of  
operations.

An opinion is disclaimed by the auditor when he has  
not obtained sufficient competent evidential matter to  
form an opinion. The disclaiming of an opinion may be  
due to a serious limitation in the scope of the examina-  
tion or to the existence of unusual uncertainties concern-  
ing the amount of an important item.

The 55 reports issued on the examinations of financial  
statements of funds during the two years ended Decem-

ber 31, 1966, included 33 unqualified opinions, 16 qualified opinions, four adverse opinions, and two disclaimers of an opinion.

Of the 16 qualified opinions, six were due to limitations in the scope of examinations, four were due to misstatements of amounts included in financial statements prepared by the state agencies, three were due to the unreliability of the records of fixed assets, two were due to the inclusion of inappropriate items in the financial statements, and one was due to failure to observe a generally accepted accounting principle. The scope of examinations was limited in the six instances because it was not considered feasible to perform the appropriate audit steps. There were no audit limitations imposed upon the Auditor General by others.

Adverse opinions were expressed by the Auditor General in reports on examinations of the following funds:

Year ended June 30, 1964

Soil Conservation Development Fund

Service Revolving Fund

Water Resources Revolving Fund

Year ended June 30, 1965

Water Resources Revolving Fund

Adverse opinions were expressed in the reports on the Soil Conservation Development Fund and the Service Revolving Fund because the financial statements included misstatements of accounts in material amounts, causing the statements to be misleading.

Adverse opinions were expressed in the reports on the Water Resources Revolving Fund for the years ended June 30, 1964 and 1965. The financial statements of the fund for these two years did not fairly present the financial position or the operating results of the fund because of material deficiencies in the accounting records and procedures. As discussed elsewhere in this report, a task force of administrative employees, with the assistance of a national firm of certified public accountants, is working toward the development of a sound accounting and reporting system for the Department of Water Resources.

An opinion was disclaimed in the report on the California Industries for the Blind Manufacturing Fund for the year ended June 30, 1965, because the auditors did

not observe beginning at themselves as material in amount opinion was California Industries Report 31, 1965.

#### **Reports on Ex**

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not observe the physical counts of inventories at the beginning and end of the year and could not satisfy themselves as to the inventory values, which were material in amount, by other means. For the same reason an opinion was disclaimed in the report on the Correctional Industries Revolving Fund for the year ended December 31, 1965.

#### ***Reports on Examinations of the Accounts of State Agencies***

During 1965 and 1964, 66 reports were issued by the Auditor General on examinations of the accounts of state agencies. These examinations of agency accounts are made on a test basis in connection with the audits of state funds. Forty-four of the reports covered agencies whose operations are financed through the General Fund, 13 reports were issued on the Division of Highways whose operations are financed through the State Highway Fund, three reports related to operations in the Correctional Industries Revolving Fund, three reports covered trust fund operations, two reports pertained to Special Deposit Fund operations, and one report covered the California Water Fund accounts of the Department of Water Resources.

#### ***Reports on Special Investigations***

It is the duty of the Auditor General to make such special audits and investigations of any state agency as requested by the Legislature or any committee of the Legislature. Requests for special investigations are approved by the Joint Legislative Audit Committee or the chairman of the committee in order to avoid severe curtailment of the regular audit program in the Office of the Auditor General. Thirty-two reports were issued by the Auditor General on special investigations during the two years ended December 31, 1966.

Of the 32 reports issued, 20 were the result of work requested by the Audit Committee. Many of these reports were requested of the committee by Members of the Legislature. Three reports were based on work requested by the Legislature and nine reports were made on work requested by other committees of the Senate and Assembly.



**Time Reported on Assignments**

The hours reported on assignments by the staff of the Office of the Auditor General for the two years ended December 31, 1966, are classified below:

Function	Total	General Fund	Special funds	Special investigations
Legislative—includes special work for committees -----	9,643	--	712	8,931
Judicial -----	58	43	--	15
Department of Agriculture -----	1,670	459	1,087	124
State Controller -----	15,835	12,189	3,602	44
Education -----	8,588	2,382	5,116	1,090
Higher Education -----	2,651	2,273	206	172
Board of Equalization -----	801	801	--	--
Secretary of State -----	60	60	--	--
State Treasurer -----	9	9	--	--
Business and Commerce -----	4,694	3,413	1,223	58
Employment -----	231	--	--	231
Health and Welfare				
Mental Hygiene -----	2,514	1,719	744	51
Public Health -----	1,408	997	341	70
Rehabilitation -----	1,225	1,026	199	--
Social Welfare -----	2,436	1,927	509	--
Public Safety				
Office of State Fire Marshal -----	1	1	--	--
Veterans' Home -----	779	246	533	--
Resources				
Water Resources -----	13,670	4,061	7,945	1,664
Conservation -----	72	18	54	--
Sundry boards and commissions --	95	95	--	--
Parks and Recreation -----	8	--	8	--
Revenue and Management				
Department of Finance -----	1,619	1,334	--	285
Franchise Tax Board -----	2,513	2,494	--	19
General Services -----	3,465	509	2,891	65
Personnel Board -----	10	10	--	--
State Employees Retirement System -----	5,132	--	5,132	--
Youth and Adult Corrections -----	1,468	694	774	--
San Francisco Port Authority -----	14	--	14	--
Transportation Agency -----	23,831	--	23,454	377
Total -----	104,500	36,760	54,544	13,196

**Expenditures**

Funds for the operation of the committee and the Office of the Auditor General are allotted in equal amounts from the contingent funds of the Assembly and the Senate by concurrent resolutions of the Legislature.

A statement of changes in the December 31, 19

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    ACR 21, 1966

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A statement of expenditures and a statement of the changes in the allotment account for the two years ended December 31, 1966, are shown below:

**Statement of Expenditures**  
**Two Years Ended December 31, 1966**

		Statement of Expenditures		
		Two Years Ended December 31, 1966		
Special funds	Special investigations		Year ended December 31 1965	1966
712	8,931			
--	15	Salaries -----	\$360,424	\$373,847
1,087	124	Employee benefits -----	28,494	30,746
3,602	44	Travel expense <sup>1</sup> -----	26,347	45,843
5,116	1,090	Committee expense -----	7,213	11,443
206	172	Office rent, moving, and remodeling expense <sup>2</sup> -----	15,291	3,913
--	--	Supplies, services, etc. -----	4,658	6,922
--	--	Equipment -----	210	140
1,223	58		<hr/> 442,637	<hr/> 472,854
--	231	Less reimbursements <sup>3</sup> -----	33,408	38,466
744	51		<hr/> \$409,229	<hr/> \$434,388
341	70			
199	--			
509	--			
--	--			
533	--			
7,945	1,664			
54	--			
--	--			
8	--			

<sup>1</sup> The increase in travel expense in 1966 is due primarily to the additional travel required for the audit of the State Highway Fund.

<sup>2</sup> The Office of the Auditor General was moved back to Room 430, State Capitol, on September 25, 1965, from leased quarters which had been occupied by the office for approximately two years.

<sup>3</sup> Reimbursements include billings for services and expenses in connection with annual audits of Long Beach Tideland revenues and expenditures: 1965, \$28,498; 1966, \$38,402.

**Statement of Changes in Allotment Account**  
**Two Years Ended December 31, 1966**

		Year ended December 31	
		1965	1966
	Allotment available at beginning of year .....	\$269,879	\$300,650
	Allotments from Assembly and Senate		
	contingent funds:		
	ACR 113, 1965 General Session .....	440,000	--
	ACR 21, 1966 First Extraordinary Session .....	--	440,000
5,132			
774		709,879	740,650
14		409,229	434,388
23,454	377		
54,544	13,196		
	Expenditures .....		
	Allotment available at end of year .....	\$300,650	\$306,262

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## **Appendix A**

### **REPORTS ISSUED BY THE OFFICE OF THE AUDITOR GENERAL DURING THE FOUR YEARS ENDED DECEMBER 31, 1966**

#### **LEGISLATIVE**

- Report on Examination of Legislators' Retirement Fund, Year Ended June 30, 1961 (April 1, 1963), 8 pp., 2 statements.
- Progress Report on Study of Long Beach Tideland Oil Trust Funds (April 30, 1963), 12 pp., appendix 11 pp.
- Summary Report on Special Study of Public School Financing (August 27, 1963), 3 pp., 1 attachment.
- Progress Report on Review of Long Beach Tideland Operations (September 19, 1963), 5 pp.
- Report on Examination of California Law Revision Commission, Year Ended June 30, 1963 (January 23, 1964), 3 pp., 3 statements.
- Report on Examination of Commission on Uniform State Laws, Year Ended June 30, 1963 (January 23, 1964), 2 pp., 2 statements.
- Report on Examination of Legislative Counsel Bureau, Year Ended June 30, 1963 (January 23, 1964), 3 pp., 3 statements.
- Annual Report on State Park Concession Contracts (February 25, 1964) 1 p. (Printed in Assembly Journal, March 3, 1964—Regular Budget Session) (Prepared in compliance with Section 5019.26 of the Public Resources Code.)
- Letter Report to Commission on California State Government Organization and Economy re Engineering Expenditures in the Division of Highways (September 25, 1964), 4 pp.
- Letter Report to Senate Fact Finding Committee on Transportation and Public Utilities re state funds expended by counties under the Collier-Burns Act of 1947 (September 25, 1964), 11 pp.
- Letter Report to Commission on California State Government Organization and Economy re Engineering Expenditures in the Division of Highways (October 15, 1964), 5 pp., appendix 1 p.
- Summary Report on Special Study of Public School Financing (December 30, 1964), 4 pp.
- Letter Report to Assembly Education Subcommittee on Special Education re analysis special education reimbursement records in the Los Angeles Unified School District (January 5, 1965), 12 pp., 2 attachments.
- Letter Report re providing support (in the 1965 Budget Bill) of the Legislators' Retirement System and the financing of an actuarial evaluation from the General Fund (February 19, 1965), 2 pp.
- Letter Report to Legislature—Annual Report on State Park Concession Contracts (March 31, 1965), 2 pp.
- Report on Examination of Long Beach Tideland Trust Funds, Year Ended June 30, 1964 (May 17, 1965), 14 pp., 9 statements.

- Letter Report—Progress Report on Financial Statements to be produced by the new accounting system of the Assembly Committee on Rules (July 12, 1965), 2 pp., 6 statements.
- Letter Report to Joint Legislative Budget Committee re review of plan to accrue state revenues starting June 30, 1967 (February 24, 1966), 4 pp.
- Letter Report to Legislature—Annual Report on State Park Concession Contracts (March 4, 1966), 2 pp. (Printed in Assembly Journal, March 8, 1966.)
- Report on Examination of Legislators' Retirement Fund, Year Ended June 30, 1965 (March 16, 1966), 7 pp., 2 statements.
- Report on Examination of Long Beach Tideland Trust Funds, Year Ended June 30, 1965 (March 30, 1966), 12 pp., 12 statements.
- Letter report on feasibility of accruing state income taxes (April 26, 1966), 2 pp.
- Letter report on availability of funds for short-term borrowing (May 4, 1966), 3 pp.
- Letter Report on tax revenue auditing requested by Assembly Committee on Government Organization (December 2, 1966), 4 pp.
- Letter Report on study of the financing of special education programs in the Public Schools requested by Assembly Committee on Education, Subcommittee on Special Education (December 22, 1966), 12 pp., 2 statements.

#### JUDICIAL

- Report on Examination of District Court of Appeal—Second Appellate District, Year Ended June 30, 1962 (February 6, 1963), 3 pp., 3 statements.
- Report on Examination of District Court of Appeal—Third Appellate District, Year Ended June 30, 1962 (February 7, 1963), 4 pp., 3 statements.
- Report on Examination of Supreme Court, Year Ended June 30, 1963 (March 26, 1964), 3 pp., 3 statements.
- Report on Examination of District Court of Appeal—First Appellate District, Year Ended June 30, 1963 (March 26, 1964), 3 pp., 3 statements.
- Report on Examination of Judicial Council, Year Ended June 30, 1963 (March 26, 1964), 3 pp., 3 statements.
- Report on Examination of Commission on Judicial Qualifications, Year Ended June 30, 1963 (March 26, 1964), 3 pp., 3 statements.
- Report on Examination of Judges Retirement Fund, Year Ended June 30, 1963 (June 1, 1964), 8 pp., 2 statements.
- Letter Report on Examination of General Fund accounts, District Courts of Appeal, Fourth Appellate District, Year Ended June 30, 1965 (February 7, 1966), 1 pp.
- Letter Report re Digest of Legislative Analyst's Report on financial status of the Judges' Retirement Fund (April 12, 1966), 2 pp., attachment 4 pp.

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# EXECUTIVE

Report on Examination of Governor's Advisory Commission on Hous-  
ing Problems, Year Ended June 30, 1963 (March 21, 1964), 4 pp.,  
3 statements.

Report on Examination of Office of the Governor, Year Ended June 30,  
1963 (April 2, 1964), 4 pp., 3 statements.

Report on Examination of Office of Consumer Counsel, Year Ended  
June 30, 1963 (April 2, 1964), 5 pp., 3 statements.

Report on Examination of Office of the Lieutenant Governor, Year  
Ended June 30, 1963 (May 29, 1964), 3 pp., 2 statements.

Report on Examination of California Disaster Office, Year Ended June  
30, 1963 (June 23, 1964), 9 pp., 4 statements.

## GENERAL ADMINISTRATION

### State Employees' Retirement System

Report on Examination of State Employees' Retirement Fund, Year  
Ended June 30, 1961 (April 1, 1963), 24 pp., 2 statements.

Report on Examination of Old Age and Survivors' Insurance Revolv-  
ing Fund, Year Ended June 30, 1961 (April 1, 1963), 8 pp., 1 state-  
ment.

Report on Examination of Old Age and Survivors' Insurance Revolv-  
ing Fund, Year Ended June 30, 1965 (May 11, 1966), 5 pp., 1 state-  
ment.

Report on Examination of State Employees' Contingency Reserve  
Fund, Year Ended June 30, 1965 (May 17, 1966), 5 pp., 2 statements.

Report on Examination of State Employees' Retirement Fund, Year  
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Letter Report on Examination of General Fund accounts, Neuropsychiatric Institute—UCLA, Year Ended June 30, 1965 (March 9, 1966), 4 pp.

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**RESOURCES****Resources Agency Administrator**

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Report on Examination of Soil Conservation Development Fund, Year Ended June 30, 1964 (February 17, 1965), 3 pp., 2 statements.

Report on Examination of Petroleum and Gas Fund, Year Ended June 30, 1964 (February 16, 1965), 2 pp., 2 statements.

**Fish and Game**

Report on Examination of Fish and Game Preservation Fund, Year Ended June 30, 1962 (March 26, 1963), 5 pp., 10 statements.

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Letter Report on an Examination of the Accounts of the Department of Parks and Recreation, Year Ended June 30, 1964 (November 18, 1964), 2 pp.

Report on Examination of the State Park Contingent Fund, Year Ended June 30, 1964 (February 17, 1965), 3 pp., 2 statements.

**Water Resources—Department of Water Resources**

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Review of Accounting System—Department of Water Resources, June 1963 (June 25, 1964), 13 pp.

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Survey of the Accounting Function of the Department of Water Resources, 1965 (August 11, 1965), 15 pp.

Report on Examination of Water Resources Revolving Fund, Year Ended June 30, 1964 (December 30, 1965), 25 pp., 2 statements.

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Letter Report on an Examination of the Accounts of the State Water Rights Board, Year Ended June 30, 1964 (November 24, 1964), 1 p.

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**Water Resources—Colorado River Boundary Commission**

Report on Examination of Colorado River Boundary Commission, Year Ended June 30, 1962 (January 23, 1963), 3 pp., 3 statements.

**Water Resources—Klamath River Compact Commission**

Report on Financial Statements for period from July 1, 1961 to June 30, 1965 (September 26, 1966), 2 pp., 2 statements.

**Water Resources—California-Nevada Interstate Compact Commission**

Letter Report on Examination of General Fund accounts, Year Ended June 30, 1965 (September 26, 1966), 2 pp.

**Water Resources—Water Quality Control Board**

Report on Examination of State Water Pollution Control Fund, Year Ended June 30, 1964 (February 17, 1965), 3 pp., 3 statements.

**TRANSPORTATION****Transportation Agency Administrator**

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Report on Examination of Department of Motor Vehicles, Year Ended June 30, 1962 (February 6, 1963), 15 pp., 5 statements.

**Department of Public Works—Division of Highways**

Report on Review of Equipment Department Division of Highways (February 27, 1963), 41 pp.

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Report on limitation of expenditure for general administration and maintenance, Section 186 of the Streets and Highways Code (December 29, 1965), 9 pp.

Report of Accounts Receivable and Related Accounting Activities (April 25, 1966), 40 pp.

Report on Review of Inventories (June 2, 1966), 18 pp.

Letter Report re rent revenue and underpayment to Los Angeles County (August 5, 1966), 2 pp.

Report on Personal Services Transactions in Connection with an Examination of the State Highway Fund, Year Ended June 30, 1966 (August 23, 1966), 20 pp.

Letter Report re district 7 embezzlement in right-of-way property rental operations (September 6, 1966), 2 pp.

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#### **Department of Public Works—Division of Bay Toll Crossings**

Report on Examination of Division of San Francisco Bay Toll Crossings, Year Ended June 30, 1963 (April 16, 1964), 19 pp.

#### **VETERANS AFFAIRS**

Report on Examination of Department of Veterans Affairs, Year Ended June 30, 1962 (January 25, 1963), 5 pp., 3 statements.

Letter Report on Examination of General Fund accounts of Veterans' Home of California, Year Ended June 30, 1965, (October 13, 1965), 2 pp.

Report on Examination of Veterans' Home of California, Post Fund, Year Ended June 30, 1965 (October 14, 1965), 5 pp., 5 statements.

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Letter Report on internal auditing within the executive branch of state government (June 4, 1963), 6 pp.

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Reimbursable Work Performed by Certain State Agencies for Other Governmental Bodies, 1964 (June 28, 1965), 15 pp.

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## Appendix B

### TEXT OF STATUTE PERTAINING TO THE JOINT LEGISLATIVE AUDIT COMMITTEE AND THE AUDITOR GENERAL

#### Article 1. Joint Legislative Audit Committee

10500. The Legislature finds that auditing is now conducted by various state agencies and recognizes the needs of the executive branch of the State Government for periodic and special audits of the revenues and expenditures of any state agency, and the accounting and fiscal reporting systems established in state agencies, as a means of insuring the proper and lawful expenditure of state funds. The Legislature, also, recognizes the necessity of an independent audit, in addition to the audit conducted within the executive branch of State Government, for the use of both the executive and legislative branches of the State Government in establishing a sound fiscal and administrative policy for the government of the State.

Therefore, it is the desire of this Legislature that the internal auditing be coordinated in the executive branch of the government in the interest of economy and efficiency. It is also the desire of the Legislature to create the Office of the Auditor General, whose primary duties shall be to examine and report annually upon the financial statements prepared by the executive branch of the State and to perform such other related assignments as may be requested by the Legislature. The authority of the office under the direction of the Joint Legislative Audit Committee is confined to examining and reporting and is in no way to interfere with adequate internal audit to be conducted by the executive branch of the government.

10501. The Joint Legislative Audit Committee is hereby created. The committee shall determine the policies of the Auditor General, ascertain facts, review reports and take action thereon, and make reports and recommendations to the Legislature and to the houses thereof concerning the state audit, the revenues and expenditures of the State, its departments, subdivisions, and agencies, whether created by the Constitution or otherwise, and such other matters as may be provided for in the Joint Rules of the Senate and Assembly. The committee has a continuing existence and may meet, act, and conduct its business at any place within this State, during the sessions of the Legislature or any recess thereof, and in the interim period between sessions.

10502. The committee shall consist of three Members of the Senate and three Members of the Assembly who shall be selected in the manner provided for in the Joint Rules of the Senate and Assembly. The committee shall elect its own chairman. Vacancies occurring in the membership of the committee between general sessions of the Legislature shall be filled in the manner provided for in the Joint Rules of the Senate and Assembly. A vacancy shall be deemed to exist as to any member of the committee whose term is expiring whenever such member is not reelected at the general election.

10503. The committee is authorized to make rules governing its own proceedings and to create subcommittees from its membership and assign to such subcommittees any study, inquiry, investigation, or hearing which the committee itself has authority to undertake or hold. The provisions of Rule 36 of the Joint Rules of the Senate and Assembly relating to investigating committees shall apply to the committee and it shall have such powers, duties and responsibilities as the Joint Rules of the Senate and Assembly shall from time to time prescribe, and all the powers conferred upon committees by Section 37, Article IV, of the Constitution.

10504. The committee shall have authority to appoint an Auditor General and a deputy who shall serve at the pleasure of the committee. The committee shall fix the salary of the Auditor General. The funds for the support of the committee shall be provided from the Contingent Funds of the Senate and the Assembly in the same manner that such funds are made available to other joint committees of the Legislature.

#### Article 2. Auditor General

10520. There is in the State Government the Legislative Audit Bureau. The bureau is in charge of the Auditor General.

10521. The Auditor General, prior to his appointment, shall possess the following minimum qualifications:

(a) He shall be in possession of a valid certificate issued by the State Board of Accountancy to practice as a certified public accountant or a public accountant.

(b) He shall have had at least seven years of experience in governmental accounting in an executive position involving responsibility for directing the work of an auditing staff of not less than 20 accountants.

(c) Or he shall have any combination of experience which in the opinion of the committee is the equivalent of (b).

10522. The Auditor General shall be paid the salary fixed by the Joint Legislative Audit Committee and shall be repaid all actual expenses incurred or paid by him in the discharge of his duties.

10523. The Auditor General may employ and fix the compensation, in accordance with Article XXIV of the Constitution, of such professional assistants and clerical and other employees as he deems necessary for the effective conduct of the work under his charge.

10524. The permanent office of the Auditor General shall be in Sacramento, where he shall be provided with suitable and sufficient offices. When in his judgment the conduct of his work requires, he may maintain offices at other places in the State.

10525. All books, papers, records, and correspondence of the bureau pertaining to its work are public records and shall be filed at any of the regularly maintained offices of the Auditor General, except:

(a) Papers or memoranda that are of no further use may be destroyed upon approval of the Joint Legislative Audit Committee.

(b) Personal papers and correspondence of any person receiving assistance from the Auditor General when such person has requested in writing that his papers and correspondence be kept private and confidential. Such papers and correspondence shall become public

records whenever they are requested by the committee or the written request of the committee.

(c) Papers, correspondence, or investigation notes of the Auditor General, disclosure of which would impede such audit.

(d) Any record restricted by law or by the Constitution.

10526. It shall be the duty of every employee of the bureau to comply with the provisions permitted by law, and to maintain the confidentiality of the information.

10527. The Auditor General shall have access to, and shall examine, all reports, vouchers, and money or other property created by the Committee. No officer or employee shall refuse to permit such examination or refuse to permit such examination to be conducted in a proper and lawful manner.

10528. The Auditor General shall have access to, and shall examine, all reports, vouchers, and money or other property created by the Committee. No officer or employee shall refuse to permit such examination or refuse to permit such examination to be conducted in a proper and lawful manner.

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(e) Papers, correspondence or memoranda pertaining to any audit or investigation not completed, when in the judgment of the Auditor General, disclosure of such papers, correspondence, or memoranda will impede such audit or investigation.

(d) Any record, document, or information, the disclosure of which is restricted by law or public policy.

10526. It shall be a misdemeanor for the Auditor General or any employee of the bureau to divulge or make known in any manner not permitted by law, any particulars of any record, document, or information the disclosure of which is restricted by law.

10527. The Auditor General during regular business hours shall have access to, and authority to examine, any and all books, accounts, reports, vouchers, correspondence files and other records, bank accounts, and money or other property, of any agency of the State whether created by the Constitution or otherwise, and it shall be the duty of any officer or employee of any such agency, having such records or property in his possession or under his control, to permit access to, and examination thereof upon the request of the Auditor General or his authorized representative. Any officer or person who shall fail or refuse to permit such access and examination, shall be guilty of a misdemeanor.

10528. The Auditor General shall examine and report annually upon the financial statements prepared by the executive branch of the State to the end that the Legislature will be informed as to the adequacy of such financial statements in compliance with generally accepted accounting principles applied on a basis consistent with that of the preceding fiscal year. In making such examination, he is authorized to make such audit examination of accounts and records, accounting procedures and internal auditing performance as the Joint Legislative Audit Committee may determine and specifically designate to be necessary to proper reporting to the Legislature in accordance with the statement of purposes set forth in Section 10500. He shall make such special audits and investigations of any state agency whether created by the Constitution or otherwise, as requested by the Legislature or any committee of the Legislature.

## Appendix C

### GENERALLY ACCEPTED AUDITING STANDARDS

In reports issued by the Office of the Auditor General on examinations of the financial statements of a fund, agency, department, or other unit, reference is made to the examination having been made in accordance with "generally accepted auditing standards." This term is used to mean the broad standards specified by the American Institute of Certified Public Accountants and widely adopted and adhered to by firms of certified public accountants. These standards are as follows:

#### General Standards

- (1) The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
- (2) In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
- (3) Due professional care is to be exercised in the performance of the examination and the preparation of the report.

#### Standards of Fieldwork

- (1) The work shall be planned adequately and assistants, if any, are to be supervised properly.
- (2) There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon, and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
- (3) Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

#### Reporting Standards

- (1) The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
- (2) The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
- (3) Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
- (4) The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

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## Appendix D

### GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Section 10528 of the Government Code states in part that "The Auditor General shall examine and report annually upon the financial statements prepared by the executive branch of the State to the end that the Legislature will be informed as to the adequacy of such financial statements in compliance with generally accepted accounting principles applied on a basis consistent with that of the preceding fiscal year." The code recognizes that financial statements to be useful to those who need to rely upon them must be based on a body of rules that are generally accepted and are applied consistently.

A body of accounting principles and procedures recommended as being generally applicable to governmental entities has been formulated by the National Committee on Governmental Accounting, which is a committee consisting of 10 advisory committees from leading accounting organizations in the United States. The Office of the Auditor General has taken the position that the accounting principles and procedures formulated by the National Committee on Governmental Accounting are applicable to the State of California and to other state governments. In expressing an opinion as to whether the financial statements of a fund or agency of the State of California present fairly its financial position as of a given date and the results of its operations for the period ending on that date in conformity with generally accepted accounting principles, the criteria used by the Office of the Auditor General have been the principles and procedures recommended by the National Committee on Governmental Accounting, together with other principles considered as being applicable to both governmental and private organizations. The recommended accounting principles and procedures are as follows:

- (1) A governmental accounting system must make it possible: (a) to show that legal provisions have been complied with; and (b) to reflect the financial condition and financial operations of the government.
- (2) If legal and sound accounting provisions conflict, legal provisions must take precedence. It is, however, the finance officer's duty to seek changes in the law which will make such law in harmony with sound accounting principles.
- (3) The general accounting system should be on a double-entry basis with a general ledger in which all financial transactions are recorded in detail or in summary. Additional subsidiary records should be kept where necessary.
- (4) Every governmental organization should establish the funds called for either by law or by sound financial administration. It should be recognized, however, that funds introduce an element of inflexibility in the financial system. Accordingly, consistent with legal provisions and requirements of sound financial administration, as few funds as possible should be established.

- (5) Depending on the legal and financial requirements mentioned immediately above, the following types of funds are recognized: (a) general, (b) special revenue, (c) working capital, (d) special assessment, (e) bond, (f) sinking, (g) trust and agency, and (h) utility or other enterprise. This classification of funds to the extent required should be followed in the budget document and in the governmental organization's financial reports.
- (6) A complete balancing group of accounts should be established for each fund. This group should include all of the accounts necessary to set forth the financial condition and financial operations of the fund and to reflect compliance with legal provisions.
- (7) A clear segregation should be made between the accounts relating to current assets and liabilities and those relating to fixed assets and liabilities. With the exception of working capital, utility or other enterprise, or trust funds, fixed assets should not be carried in the same funds with the current assets but should be set up in a self-balancing group of accounts known as the general fixed asset group of accounts. Similarly, except in special assessment and utility funds, long-term liabilities should not be carried with the current liabilities of any fund but should be shown in a separate self-balancing group of accounts forming part of the general bonded debt and interest group of accounts.
- (8) The fixed asset accounts should be maintained on the basis of original cost, or the estimated cost if the original cost is not available, or, in the case of gifts, the appraisal value at the time received.
- (9) Depreciation on general governmental fixed assets should not be computed unless cash for replacements can legally be set aside. Depreciation on such assets may be computed for unit cost purposes even if cash for replacements cannot legally be set aside providing these depreciation charges are used for memorandum purposes only and are not reflected in the accounts.
- (10) The accounting system should provide for budgetary control for both revenues and expenditures, and the financial statements should reflect, among other things, budgetary information.
- (11) The use of the accrual basis in accounting for revenues and expenditures is recommended to the extent applicable. Revenues, partially offset by provisions for estimated losses, should be taken into consideration when earned, even though not received in cash. Expenditures should be recorded as soon as liabilities are incurred.
- (12) Revenues should be classified by fund and source; and expenditures by fund, function, department, activity, character, and by main classes of objects, in accordance with standard classifications.
- (13) Cost accounting systems should be established wherever costs can be measured. Each cost accounting system should provide for the recording of all of the elements of cost incurred to accomplish a purpose, to carry on an activity or operation, or to complete a unit of work or a specific job. Although depreciation on

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- (14) A common terminology and classification should be used consistently throughout the budget, the accounts, and the financial reports.

## APPENDIX E

### RULES OF THE JOINT LEGISLATIVE AUDIT COMMITTEE

The committee operates under the following rules, which were adopted in accordance with the authority granted in the enabling act:

- (1) The officers of this committee are a chairman and vice chairman, and the committee shall appoint an Auditor General who shall act as secretary.
- (2) Four members of the committee shall constitute a quorum; provided, however, that such number shall include no less than two members from the Senate and two members from the Assembly.
- (3) Any action of the committee shall require an affirmative vote of not less than two of the Senate members and two of the Assembly members of the committee.
- (4) The chairman of the committee is authorized to appoint subcommittees, to specify their duties, and to designate the membership of the subcommittees.
- (5) The chairman is authorized to fix the time and place of each meeting of the committee and shall give each member reasonable notice of each meeting.
- (6) The chairman shall preside at meetings when present, and in his absence the vice chairman shall preside. The vice chairman of this committee shall act as chairman in the case of a vacancy in the office of the chairman, or whenever such authority is delegated by the chairman.
- (7) The secretary shall keep a complete record of the meetings of the committee and of action taken by it.
- (8) The committee shall reorganize and elect new officers prior to the adjournment of each general session of the Legislature. The officers of the committee shall hold office until their successors are elected and have qualified.
- (9) The Legislative Counsel shall be the counsel for the Joint Legislative Audit Committee.